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TAXATION IN AUSTRALIA AND NEW ZEALAND

HAROLD M. GROVES *

STARTING with a few general impressions of taxation in Australia and New Zealand, one may observe first that the subject is not characterized by simplicity. One soon arrives at the conviction particularly with regard to Australian taxation that if the taxmakers had deliberately set out to make their system as complicated as possible they might well have ended with existing institutions and practices. This conclusion is reached after due discount for the difficulty of any outsider in understanding domestic institutions that seem simple enough to those who have grown up under them. The complications of the Australian system are a matter of frequent criticism at home; [1] they do provide some outlet for the Australian's unsurpassed sense of humor, but the fun is mixed with several grains of frustration. And in New Zealand a favorite joke among "tax men" alleges that the tax commissioner of Australia requires two hours to compute his own income tax liability after all the facts are in.

General Characteristics

The complications of the Australian income tax (the principal villain in the piece) are due to:

1. The fact that under the cabinet system the intellectuals (professional administrators) play a larger role in writing tax laws than here; there is less censorship by the lay legislator;
2. The traditional use of formulas to achieve smooth progression;
3. The regular calculation of tax by the administrator rather than the taxpayer, which leads to the conclusion that the taxpayer need not understand the devious and tortuous process by which his bill is determined;
4. The rebate system allowing for certain deductions as a subtraction from tax rather than from income (explained later);
5. Elaborate differentiation in tax upon "earned" and "unearned" (property) income; and

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[1] For example, the following is quoted from the Hobart *Mercury* in *The Taxpayers Bulletin* (published by the Taxpayers' Association of New South Wales, Sydney), XVII (July 1, 1948), 115: "Taxation acts and regulations, with amendment piled on amendment, have developed into a chaotic mass of complexities. They are now a maze into which few but trained accountants can venture with any confidence. And there is not the slightest need for taxation to be so complicated."

6. The British convention of expressing tax rates as pence in the pound rather than as a percentage; the neophyte is utterly confounded until he learns to *think* in terms of British money.

On the other side of the picture, the monopolization of the income tax by the Federal Government is a mitigating factor. The Australian can extend sympathy to the American interstate business that has to keep not only a Federal tax service on its shelf but also some dozen or more state services.

In general, taxes in Australia and New Zealand are at least as high as ours (in relation to national income) and probably somewhat higher. Calculating a ratio of taxes to national income is a hazardous undertaking but a figure of over 30 per cent is accepted in Australia and the one for New Zealand is probably not much less.[2] Taxes in the United States have been reduced too recently to give a current figure for this country but it seems improbable that the ratio in recent years has ever reached 30 per cent. (The figure for 1947 appears to be slightly less than 26 per cent).[3] Federal direct taxes in the middle brackets are much higher in the South Pacific countries than here. In Australia the income tax on a taxpayer with a wife and one dependent and an income of $3,250 is at least three quarters higher than three times as high as our Federal levy (with allowance for social security payments). At the upper and lower end of the scale the difference disappears. Tax reductions in the South Pacific since the war have been substantial but as in this country tax levels remains much above prewar; military expenditures have been sharply reduced but expenditures on the social services have largely filled the gap. State and local taxes, particularly those on property, are much less than ours. On the expenditure side, the outlays for social security are very high. In New Zealand expenditures in this area are of a magnitude comparable with our outlay for military purposes. Expenditures for education are lower than ours while much less is spent for military purposes, particularly in New Zealand.

Postwar tax reductions in both countries have been comparable to our own. They include a repeal of wartime excess profits taxes. The reductions in personal tax have favored the lower brackets. The 1948 New Zealand budget presented by Walter Nash, Minister of Finance in August, 1948, carried an income tax rebate of £10 for each taxpayer, an idea frankly borrowed from President Truman's proposal to the 80th Congress.

As previously suggested, the social security system figures more heavily in the South Pacific revenue systems than in ours. Moreover, the social security taxes are largely integrated with the net income tax and no pretense is made of following the contributory principle. In Australia the main special support for social security is an addition to personal income tax rates. Persons with incomes of less than £104 per year and

[2] See footnote 20 at the close of this article. A figure of 26.2 per cent for New Zealand (1947-48) is offered provisionally by the Government Statistician who first deducted a very substantial item of subsidies from the tax total. *New Zealand Official Estimates of National Income*, Wellington, 1948. Average per capita income in these countries, while high, is considerable lower than in the United States—a fact which makes the 30 per cent ratio more significant.

[3] Tax figure of $52,429 million is taken from Tax Institute, *Tax Policy*, August, 1948; income figure of $203.1 billion from *Economic Indicators*, prepared for the Joint Committee on the Economic Report, Washington, June, 1948.

no dependents are exempt; the exemption is higher for persons with dependents. Rates are graduated up to a maximum of 1/6*d* in the pound (7.5 per cent). The social security tax system of New Zealand consists of a 7.5 per cent net income tax applicable to both companies and natural persons and without benefit of any personal credits. Companies are not included in the Australian system except that they pay a payroll tax on wages in excess of £20 per week.

Both countries have an elaborate system of benefits to cover most if not all of the hazards of life. This includes family endowment (for each child in New Zealand and each after the first in Australia); old age insurance (New Zealand has two varieties, one with and one without a means test); medical assistance (covering most expense associated with medical advice, hospitalization, and drugs in New Zealand); and generous benefits for time lost in either unemployment or sickness. Of these items family endowment and old age pensions are the most expensive. All told, the bill for social security runs to a third of the New Zealand national budget and is roughly one-tenth of the national income. Not only has the government left no stone unturned in its effort to take the worry and hazard out of life, but in addition, its security program aims at the more radical objective of pay according to need. Basic wages are adjusted to the needs of small families and the greater responsibility of larger ones is covered by family endowment.

The governments of the South Pacific countries are noted for their equalitarianism. It is said that in these countries men mix enough water with good wine so that there may be enough for everybody. It is a commonplace that the spread between rich and poor is less than in the United States, and some of this is due, no doubt, to public policy. Equalitarian objectives are less apparent in the tax system than in social security benefits, wage control, and the promotion of trade unionism. But they appear to some extent in the favor given to necessities in the high protective tariff and sales taxes and in the differentiation of the income tax in favor of service income.

That the Australian tax system, particularly, is "tough" on incentives would be hard to deny. The combination of high personal tax, double taxation of corporate profits and dividends, differentiation in the personal tax unfavorable to property incomes, and an undistributed profits tax seems about as unfavorable to investment incentives as any that could be devised. Yet life and business do go on somehow and standards of living are still among the highest in the world. Curiously, the local tax system, based largely on unimproved land values, gives unusual stress to incentives.

The pervasiveness of government, especially in New Zealand, is most impressive. On the police side, one encounters licensing of imports, new business, and new labor unions; determination of basic wages and differentials; approval of union rules; compulsory arbitration of labor disputes; price control. On the proprietary side the government owns and operates mines, railroads, air transport, banks (including one trading bank), broadcasting, tourist service, an insurance company, much housing, and a legal service (assistance in making wills, investments, and so

forth). The government subsidizes freely and markets farm products abroad for the primary producer. To this, of course, is added the elaborate social security system previously described. When one then takes account of the relatively undeveloped state of private enterprise outside agriculture, he gets an idea of the extremely predominant role played by the government. He hastens then to inquire (remembering Hayek) about the effectiveness of public opinion as the ultimate master of this Frankenstein monster. He is reassured to find an extremely alert, well-informed, sharply divided, and almost universally participating electorate. Some concern is expressed lest tyranny and suppression might yet raise their ugly heads out of this thick web of government. But it is plain enough to the observer that this has not happened yet.

The Uniform Tax Plan

The greatest achievement in Australian tax history, according to many Australians, is the merger of state and Federal income taxes which was consummated during the war and retained in the postwar period. Prewar state income taxes were characterized by stiff rates, differing widely, however, from state to state; by jurisdictional conflicts; and by special levies on certain income such as wages and salaries. Substantial progress toward a coordinated system had been made, however. During the 'twenties agreement had been reached to eliminate duplicate administration; the states were to administer the Federal income tax along with their own in five states; and in West Australia the Federal Government would manage the two levies. This arrangement worked well and was justly publicized in this country as a great achievement. In addition, a uniform set of income tax provisions (exclusive of rates and exemptions) was accepted in conference, and real progress was made in promoting the general acceptance of this measure. Still further, the Commonwealth had always allowed deductibility of state taxes in calculating its own tax and this procedure reduced interstate differences in the burden of the combined taxes. Nevertheless, the system did not survive the strain of the war. The uniform tax measure of 1942 was adopted over the unanimous protest of the states. The war measure was taken to court and sustained. Moreover, it appears from the court's decision that the right of the Federal Government to pre-empt this tax did not depend upon the defense power and could be exercised in peace time.[4]

During the war, income tax revenue returned to the states was at the level of the average income tax collections in prelegislation years. The figure was raised somewhat for 1946-47 and 1947-48 after which it would gradually advance (a) in proportion to total population increase in the six states and (b) by a percentage equal to half the percentage increase in average wages. (This is an escalator provision to take account of changes in productivity and the value of money.) As to relative distribution among the states, a

[4] Actually, of course, the Federal law did not and does not prohibit state income taxation but (a) gives the Commonwealth priority in the collection of its tax and (b) makes grants conditioned upon states' abstention from the field. See *South Australia and others* v. *Commonwealth of Australia*, 2 A.I.T.R. 273, 65 C.L.R. 373. See also discussion in J. A. L. Gunn, *Commonwealth Income Tax Law and Practice* (2d ed.; Sydney: Butterworth and Co., 1948), pp. 97-104.

complicated formula was added, providing for a gradual change over the years in favor of states with growing population (with special emphasis upon the age group 5 to 15 years) and of states whose population is sparsely distributed. The emphasis on the junior age group means that school children will count four times as much as their elders. The formula will thus extend increasing grants to states that need to provide increasing educational facilities.

Australia has several well-developed institutions of intergovernmental fiscal coordination that have no counterpart in the United States. The fountainhead of policy in the area of Federal-state relations is the Premiers Conference (of Commonwealth and state ministers) which meets often and deals with a wide range of problems. Another body with both Federal and state representation is the Australian Loan Council. This group arose from a financial agreement between the Commonwealth and states in 1927. (Contracts among federal and state governments—a common occurrence in Australia—are not used in the United States, though our interstate compacts are a beginning in this direction.) The Australian Loan Council in effect rations credit and centralizes the arrangement and security for debt. Finally there is the Commonwealth Grants Commission, a body of three appointed to recommend special-need grants to the weaker states (not to be confused with the distribution of Uniform Tax revenue). The commission has regularly recommended substantial grants to three of the six states. The standard applied is that of allowing a uniform minimum standard of government at uniform state cost. Some account is also allegedly taken of the quality of state administration. This discretionary system has been criticized as too subjective and inimical to state incentives. Some critics hold that it would be better to tie the grants to differentials in average per capita income. However, the commission takes the view that "no fixed formula can suitably be applied." The commission's recommendations have always been accepted without modification by the Federal Parliament. In the case of the three so-called "mendicant" states this special aid from the Commonwealth runs to more than one-half the amount these states raise locally.[5]

As previously stated, opposition to this highly centralized revenue system is considerable. The premier of New South Wales said of the scheme in 1942: "If you take away the power to tax, you take away the power to govern."[6] Also frequently quoted is the prophetic statement made by the Honorable Alfred Deaken in 1942: "As the power of the purse in Great Britain established by degrees the authority of the Commons, so it will in Australia ultimately establish the authority of the Commonwealth. The rights of self-government of the States have been fondly supposed to be safeguarded by the Constitution. It has left them legally free, but financially bound to the chariot-wheels of the Commonwealth. Their need will be its opportunity."[7] There is considerable ground for the belief

[5] See *The Work of the Commonwealth Grants Commission* (Canberra, 1945) and Commonwealth Grants Commission, *Fourteenth Report* (Melbourne, 1947).

[6] Commonwealth Office of Education, *Uniform Taxation* (Current Affairs Bulletin, 1948), p. 15.

[7] I. W. K. Hancock, *Australia,* (Australian ed.; Sydney: Australian Publishing Company, 1945), p. 97.

that the Australian federal system has served its usefulness and operates currently mainly as a brake to positive action. It will be recalled that the New Zealanders abandoned their federal system in the eighteen seventies. But even without a federal system there would persist a problem of a financial base for virile local government.

The Net Income Tax

Formula Progression.—An impressive feature of the personal net income tax of Australia is graduation by formula aimed to create a smooth curve of progression stepped up evenly from pound to pound of income. More accurately, the system provides consistent progression within a series of ascents flattening out (degressively at the top. Rates are applied to the totality of income rather than to portions as in our system; no (" notch ") problem arises in the transition from bracket to bracket because the width of each bracket—one pound—is negligible and the step up therefore can be very gradual.

Suppose a tax schedule that started with 1 cent on the first dollar of taxable income and increased by one-hundredth of a mill on each dollar thereafter up to $10,000, the marginal rate to apply to the entire income whatever it might be. This method would result in a rate of approximately 11 per cent (10.999) on a $10,000 income and would provide a steady increase in the effective rate throughout the schedule. This in substance is the way the Australians apply progression.

Although the principle of progression thus applied is plausible and fairly simple, the actual formulas developed in the Australian laws and literature are notoriously complex. The original law of 1915 with rates devised by Sir George Knibbs specified for property income, curves of the second and third degree. The Australian Yearbook (No. 36) gives the schedule of rates for 1946-47 starting with the following formula for personal exertion income within the income classification £201-£300: the tax in pence is equal to $.06\ T^2$ plus $12T$ minus 4800, where T is taxable income in pounds.[8] No explanation is offered as to how this formula is derived. Certainly these mathematics mean nothing to the layman. Tax tables and " ready reckoners " of course can be used by the taxpayer to approximate his tax, but he never knows exactly how it is calculated. Perhaps it is not necessary for him to know, but the author gained the impression that the taxpayer's morale suffers when his natural curiosity about the mechanics of his tax is frustrated. The following—addressed to the Prime Minister—from a taxpayers' bulletin bears out this impression: [9]

[8] Or take this one from an earlier yearbook:

$$R_a(\text{rate}) = \frac{5533.3}{I\ (\text{taxable income})} - 5 + \frac{12.583}{10^3} \cdot$$

$$I - \frac{1.06}{10^6} \cdot I^2 + \frac{.03}{10^9} \cdot I^3$$

Use of actual formulas in the law itself was discontinued during the war period. The first schedule of the 1945 Act (No. 38) starts as follows: "If the taxable income does not exceed £200, the rate of tax shall be nil. If the taxable income exceeds £200 but does not exceed £300 the rate of tax for every pound of taxable income up to and including £200 shall be 3 pence, and the rate of tax for every pound of taxable income in excess of £200 shall be 36.15 pence increasing uniformly by .15 of one penny for every pound by which the taxable income exceeds £201."

[9] Taxpayers Association of New South Wales, *The Taxpayers Bulletin*, (Sydney, August 1, 1948), p. 136. One also recalls the renowned passage from Adam Smith's *Wealth of Nations*: "The tax which each individual is bound to pay, ought to be certain, and not arbitrary. The time of payment, the

I'm worried Mr. Chifley
With the bill you sent to me.
It's complex and it's difficult
To understand you see.
I've puzzled and computed
By math and graphs and Euclid.
Would you really say I'm stupid,
Mr. C.?

Nevertheless, the system has been commended by the Royal commissions of investigation. One of them observed that straightline progression "is more scientific and not more difficult either to understand or apply" than other systems.[10] Another commission thought the curves in use actually approximated the marginal utility of income of taxpayers.[11] Considering the unknown and the unknowable in this area, one should be permitted to take this with a considerable pinch of skepticism.

The New Zealanders' personal income tax is graduated like our own except that brackets are narrowed to a width of £100. Thus on the standard schedule the rate on taxable income is 2/6 (2 shillings, 6 pence) on the first £100, 2/9 on the second, 3/- on the third, and so forth.

Rebates.—A second interesting feature of the Australian law is the allowance of tax rebates in lieu of personal deductions and credits. Instead of allowing these concessions in the familiar form of subtractions from the tax base, the Australians add up the tax first, then calculate the tax value of the concessions, and subtract the "rebate" from the tax. Frequently a ceiling is provided for the rebate. (Thus the allowance for a spouse is £150 but the rebate may not exceed £45. The ceiling appears to be a survival of the vanishing exemption system that was once featured in the Australian law.) Something similar to this is provided in some of our state income tax laws but there the rebate applies to personal allowances only. The Australian concessions cover an elaborate set of allowances not only for dependents but also for such items as certain nonbusiness taxes, medical expenses, contributions, and insurance. They are calculated at the personal service rate of tax plus the social security contribution rate. They serve the revenue better than deductions because: (1) they do not reduce the base on which the graduated rate is calculated; and (2) they make no allowance for the higher rates on property income.

The New Zealanders lean toward austerity in their provision for personal deductions; none are permitted. Subtractions are confined to business and professional expenses and personal credits for the taxpayer and dependents. There is much to be said for this practice but the complaint is heard from educational and philanthropic institutions that the system discourages donation.

Differentiation of Service and Property Income.—An outstanding feature of income tax laws in the South Pacific is their radical differentiation between service and property incomes. In general, the differentiation runs about a quarter in the Australian rate schedule and about a third in that of New Zealand.[12] The Australian definition of property incomes includes dividends,

manner of payment, the quantity to be paid ought all to be clear and plain to the contributor, and to every other person...."

[10] *Third Report of the Royal Commission on Taxation*, 1934, p. 94.

[11] *The Report of the Royal Commission on Taxation*, Second Report, 1922, p. 98.

[12] This differential tapers off at both ends of the graduated scale.

while the New Zealand definition is confined largely to interest and rent. Neither includes the receipts from unincorporated business. The dual schedule adds another complication since it is especially difficult to apply in the case of mixed incomes. It also raises many controversial questions of tax policy. One may quarrel with the specific classification. For instance, the Australian tax measures seem to single out corporate profit income for much higher taxes, other things being equal, than noncorporate profit income. One may also take issue with the pronounced degree of differentiation. And one may even doubt that, in combination with other taxes, differentiation provides a more equitable tax than straight quantitative graduation.

Averaging Income.—The Australians have also had a unique experience with the averaging of income. For many years all income was subject to averaging, but in recent years only the primary producers have enjoyed the benefit of this feature. Most interesting is the fact that under Australian averaging the actual income of each year constitutes the base of each year's tax, but the rate applied is one appropriate to a figure derived from a five-year running average. (Thus, if the current income is 3,000 and this income carries an effective rate of 20 per cent and the average income is 2,000 with an effective rate of 10 per cent, the tax is 10 per cent of 3,000 or 300.) A few simple calculations will show that the Australian system involves less fluctuation in tax than would a system that followed the average as to both base and rate. The general application of averaging (introduced in 1922 and used for fifteen years) was repealed following criticism of the type usually advanced against the feature, namely, that it was troublesome to administer and unpopular during bad years.[13] Nothing like the Australian technique has ever been tried or proposed in this country except perhaps for capital gains. Here the proposal for averaging would apply a rate to the gain based upon the actual gain divided by the years of accrual. The Australian system would be more difficult to apply under our rate system than under theirs, but it has some possibilities worth considering, especially in the treatment of capital gains.

Miscellaneous Features.—Current payment of taxes was inaugurated in Australia during the war. Except by special dispensation, the taxpayer is required to make quarterly payments based upon his previous year's income. This rule is stricter than ours and causes considerable complaint from those whose current income shows a decrease. Of course these people are entitled to refunds ultimately but time may be important. New Zealand uses withholding, as does Australia, but has no further provisions for current payment. As to joint and separate returns, the Australian provision is substantially that in the United States before the recent law enacted by the 80th Congress; New Zealand follows the British with

[13] The problem of averaging was discussed at length in the *First Report of the Royal Commission on Taxation*, 1920, pp. 4-24. The Australian system as described above was enthusiastically recommended. British experience was considered, and the recommended plan was thought advantageous because it would not "seek payment from persons who may be in financial straits, insolvent or fugitive." (p. 21). Repeal except for primary producers was recommended by a second Royal commission, *Third Report of the Royal Commission on Taxation*, 1934, p. 110.

mandatory joint returns. Imputed income (as in the case of the annual value of owner-occupied homes) is not taxed. Treatment of capital gains and losses generally follows British precedent.[14] Gambling gains and losses are ignored, a distressing feature considering the load that is put upon legitimate means of economic advancement. As in England, annuities are generally taxable, even when they represent a return of capital. Depreciation allowances are somewhat less general than our own. A provision permitting such allowances to be figured each year as a percentage of original cost minus previously deducted depreciation wisely makes for a concentration of the deductions in the early years of the life of the asset.

Taxation of Corporate Income and Dividends

Both Australia and New Zealand classify corporations into two groups. One group is termed "private" or "proprietary" companies and is distinguished mainly by the fact that its stock is closely held. The other group is called "public" companies. The definition of a private company in Australia includes firms controlled by seven or fewer persons and which are not companies "in which the public are substantially interested" or subsidiaries of public companies. In New Zealand a "proprietary" company is one that at the end of the year is under the control of not more than four persons. In both cases undistributed income is taxed as though it had been distributed to stockholders[15] but in the Australian system, curiously, the tax though calculated on the individual scale is assessed to and collected from the corporation.[16] Penalties attached to reinvestment with intent to avoid personal taxes (as in our notorious section 102) are deemed unnecessary.

All corporations, public and private, pay a general corporation tax, amounting to roughly 30 per cent in Australia and to a 55 per cent maximum in New Zealand. Australian public corporations pay an additional 5 per cent "supertax" on income in excess of £5,000. Australian public companies also pay an additional tax of 10 per cent on undistributed profits; and any excess of distribution over capital costs is considered an ordinary dividend at time of liquidation. Bonus shares (stock dividends) that constitute "a capitalization of profits" are ordinarily taxable to individuals.

Dividends are subject to the personal tax in Australia[17] but not in New Zealand.[18] The Australian combination of levies on profit income is impressive for its duplication; the New Zealand system involves no duplication but the initial rate on corporations is impres-

[14] Gain and loss on sale of property acquired for disposition at a profit is taxable; this rule is highly ambiguous and difficult to apply. See Gunn, *Commonwealth Income Tax*, pp. 220-239.

[15] The income thus treated is given the euphemistic and ingenious title of "notional income."

[16] In New Zealand, while the income of a proprietary company is divisible among all the shareholders, the treatment is applied only to those whose share is not less than one-fifth the total income.

[17] Through the operation of a rebate, dividends received by a corporate stockholder are not ordinarily subject to a second tax.

[18] In New Zealand, where proprietary income is included in the taxable income of the shareholder, any dividends derived from a proprietary company are disregarded, and a credit is allowed against the tax payable by the shareholder on the proprietary income, this credit being equal to the tax payable by the company in respect of that income.

sively high. The New Zealand system, moreover, exempting dividends at the personal level as it does, is open to the criticism that it precludes the application of the progressive scale to such income. This unfortunate consequence is mitigated somewhat by including dividends in the measure though not the base of the personal tax.[19] Though not themselves subject to tax, dividends count in the determination of the rate applied to other income. But this provision is of no value if the taxpayer receives his entire income from dividends. The New Zealand system (high corporate tax and exemption of dividends to stockholders) is defended curiously on the ground that corporation taxes are easy to bear since they are taken into account in the administration of price control. What this means in terms of the incidence of the tax is a matter to ponder.

Other Taxes

Space does not permit more than passing mention of other features of these interesting tax systems. None of our important taxes is overlooked. Sales taxes in Australia range through three classifications of commodities taxable at 7.5, 12.5, and 25 per cent with the middle classification regarded as standard. In New Zealand the rate is 20 per cent. These look much higher than our state taxes of a similar vintage but the laws provide so many exemptions that they are perhaps more comparable to our special excises than to the more general levies.

Both South Pacific countries have graduated taxes on unimproved land values (above a specified exemption). These are not to be confused with the local taxes, also (though not exclusively in all muncipalities) based upon unimproved land values. The former taxes were originally imposed to break up large holdings in land. They are relatively moderate, not very productive of revenue, and probably not very effective in limiting the size of holdings. Their nonfiscal purpose is subject to criticism for not taking into account the optimum size of holdings in such various pursuits as general farming, ranching, and merchandising. In the case of corporate holdings they require proration of collectively held land among stockholders. The local tax upon unimproved land, in contrast, is a genuine attempt to recapture economic rent. It has major popular support and can be judged successful though the load it carries is not comparable with that of our general property tax. The function of education, for instance, is maintained exclusively out of state and national funds. As previously suggested, a principal argument presented for confining the local tax to land is that this policy spares the incentives to improve sites.

Estate and succession taxes in the two countries offer little that is unique. Rates are not conspicuously high compared with our own or with other taxes in the tax system of these countries. Exemptions are much lower than in our Federal death tax. In Australia, state and Federal taxes in this area (and in that of land taxation) overlap but there has been no important urge to nationalize these levies as in the case of income taxes.

[19] Charles A. Staples, *A Guide to New Zealand Income Tax Practice* (1948 ed.; Wellington: Financial Publications, Ltd.), p. 173.

Conclusion

No attempt will be made here to appraise these tax systems or to analyze further the points where we could profit by their example. It can be said, however, that these countries afford an unusual opportunity for comparative study of tax institutions. They have shown an unusual penchant for experimentation, fostered to some extent no doubt by their isolation. At any rate, few countries have shown so much defiance of "the truculent, narcotic, and despotic past." Now that communication between these countries and our own has greatly improved and a much greater community of interest has been established, it may be hoped that the tax experience of each may become better known to the other.[20]

[20] This article is based on the situation in the South Pacific countries prevailing in the summer of 1948. A fairly substantial reduction of taxes in Australia was announced by the Prime Minister in his budget speech of September, 1948. The reduction is about 16⅔ per cent of the total amount formerly paid by individuals. The percentage reduction is substantially greater in the lower and middle income groups. The flat rate of tax on companies was reduced from 6 shillings to 5 shillings in the pound on the first £5000 of taxable income (Letter from P. S. McGovern, Commissioner of Taxation, Canberra, January 10, 1949).

LEGISLATIVE HISTORY OF TREATMENT OF CAPITAL GAINS UNDER THE FEDERAL INCOME TAX, 1913-1948

ANITA WELLS *

THE LEGISLATIVE history of capital gains taxation under the modern income tax may be divided into four periods. During the first period, which extends from the enactment of the 1913 law through 1921, capital gains of all types were subject to the same rates of taxation as other income. There was considerable variation in the recognition of capital losses, beginning with no allowance and followed by gradually widening recognition, first to the extent of capital gains, and finally to full allowance against income of any kind. During the second period, covering the income years 1922 through 1933, capital gains from long-term transactions were segregated and a maximum rate of 12.5 per cent applied to them, again with a varying policy in the treatment of losses. At first losses were allowed in full against income of any kind; later they were subjected to the so-called parallel treatment which applied the same flat rate limitation to losses as to gains. A third period was inaugurated by the Revenue Act of 1934, effective until 1938, with its plan of percentage inclusion of gains and losses, according to the length of time the assets had been held. Under this plan the gains taken into account were included in net income and subjected to full normal and surtax rates, while losses taken into account were deductible only to the extent of recognized gains plus $2,000. The Revenue Act of 1938 began the fourth or present period which combines some features of the two preceding periods, namely, percentage inclusion of gains and losses and an alternative flat rate tax. The treatment of losses during this last period has fluctuated widely from a policy of rather severe restriction to a policy of more liberal allowances.

FIRST PERIOD: TAXATION OF GAINS AT FULL RATES, 1913-1921

Revenue Act of 1913

The 1913 law included in the definition of net income " gains, profits and income derived from . . . sales, or dealings in property whether real or personal . . . ." General provision was made for the deduction of losses " incurred in trade," but there was no provision for the deduction of losses incurred in property transactions undertaken otherwise than " in trade." Under this provision, the Treasury treated all profits from the sale of property exactly as other items of income, imposing upon

* The author is an economist in the Division of Tax Research, U.S. Treasury Depeartment. She has received many helpful criticisms and suggestions from Marius Farioletti, under whose supervision the study was made. Opinions expressed are those of the author and do not necessarily reflect official views of the Treasury Department.

them the full normal and surtax rates. Profits from casual investments, not connected with the trade or business, were included in the tax base but losses from such transactions were not even recognized as deductions to the extent of gains from similar transactions during the same taxable year.[1]

Revenue Act of 1916

The 1916 Revenue Act liberalized somewhat the treatment of losses by allowing the deduction " in transactions entered into for profit but not connected with his business or trade " but " not exceeding the profits arising therefrom." [2]

Revenue Act of 1918

A significant change in the 1918 Revenue Act was the elimination of the restriction upon the deduction of capital losses. All losses incurred in any transaction entered into for profit (though not connected with the trade or business) were made deductible, even though they exceeded in amount the capital gains.[3] The 1918 law also marks the beginning of the " net loss " and " exchanges " provisions of the present day statute.[4] " Net loss " under the 1918 act included not only operating losses but capital losses from the sale of plant, buildings, machinery, or other facilities acquired by the taxpayer on or after April 6, 1917, and used in the production of articles contributing to the prosecution of the war.[5] " Net loss " could be applied first against income of the preceding taxable year (involving redetermination of the tax) and then, if there was any excess, carried forward to the succeeding year.

SECOND PERIOD: MAXIMUM RATE OF 12.5 PER CENT, 1922-1933

Revenue Act of 1921

Although income tax rates were increased significantly during World War I, the only major concession extended to capital gains in this period was the widened recognition gradually extended to capital losses. Proposals for special treatment of capital gains were discussed in 1919 and 1920, but it was not until the enactment of the Revenue Act of 1921 that such treatment was provided.

One of the early proposals which received serious consideration was H.R. 14198, 66th Congress, 2d session, which passed the House on May 27, 1920, but failed to receive the approval of the

[1] T.D. 2135. (1915) A question relating to the treatment of losses from casual stock transactions had been brought up for discussion on the floor of the House during debate on the income tax bill and Mr. Hull had expressed the opinion that " if he is simply making a casual investment of that kind now and then, or here and there, I think he would report his gains for taxable purposes, and probably would be allowed for his loss. It would not be a trade loss, but set off against the particular gain from the other stock transaction." He added further: " The question would arise whether he is making that a business. There are ample adjudications as to all these kinds of transactions which will make it easy, I think, for the Secretary of the Treasury to make the taxpapers acquainted with their exact application and relation to the tax." (*Congressional Record*, Vol. 50, p. 513, April 26, 1913)

[2] Section 5(a) Fifth.

[3] Section 214(a)(5).

[4] Prior to the 1918 act the income tax law had no specific provision with respect to taxability of gain or allowance of loss from exchange of property. The 1918 act provided " when property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any . . . ." [Section 202(b)]

[5] Section 204(a). This provision was applicable only to net losses sustained in the period October 31, 1918, to January 1, 1920.

Senate. This proposal included a proration plan for taxing "extraordinary net income," defined to include (1) compensation for personal services rendered during a period of more than three years and (2) gains from sales of capital assets held more than three years. If the "extraordinary net income" amounted to more than 20 per cent of the taxpayer's entire gross income for the taxable year, the "extraordinary net income" could be apportioned ratably to the years during which the service was rendered or the assets held, and the amount thus apportioned to any year would be added to the other income for that year and the tax redetermined upon the corrected amount at the rates applicable to that year.[6]

The enactment of the Revenue Act of 1921 marked a radical change in capital gains tax policy. The capital gains clause was introduced and for the first time Congress defined the term "capital assets."[7] Gains from capital transactions were divided into two groups, the first consisting of gains from assets which had been held for more than two years, and the second of gains from assets held two years or less. Gains from short-term transactions were to be included with other income and taxed at full normal and surtax rates and losses from such transactions were to be allowed in full in computing net income. Special treatment was provided for gains from long-term transactions. The taxpayer was given the right to segregate such gains and pay a special flat tax of 12.5 per cent in lieu of the normal and surtax rates, with the provision that the total tax, including the tax on capital net gains, could in no case be less than 12.5 per cent of the total net income. Under the then applicable rates and exemptions, the benefits from the special treatment accrued only to taxpayers with surtax net incomes in excess of $16,000.

This special flat rate tax for long-term capital gains was provided in response to claims that the application of the full normal and surtax rates was operating to prevent the closing of many transactions. The combined normal and surtax rates during the war had reached a maximum of 77 per cent

[6] Section 3, H.R. 14198, 66th Cong., 2d sess. This type of special treatment had been recommended by Secretary of the Treasury Houston in a letter dated March 17, 1920, to the Chairman of the Ways and Means Committee. (See Secretary of the Treasury, *Annual Report* for the fiscal year 1920, pp. 31-32.) In an earlier communication (November 3, 1919), Secretary of the Treasury Carter Glass had offered another suggestion, without recommendation, for special treatment of "extraordinary income" defined as above. If "extraordinary income" amounted to not less than 50 per cent of the taxpayer's ordinary income for the taxable year, such income would be considered the income of the first year in which it could be definitely determined but the taxpayer could report it separately from ordinary income and apply the normal tax rate of the year in which the income was determined plus 25 per cent of the extraordinary income. In connection with this suggestion, it was pointed out that those who supported this method favored it because "it is obviously undesirable to reopen and amend the returns of prior years for the purpose of prorating such income." (Notes on the Revenue Act of 1918, submitted by the Secretary of the Treasury, without recommendation, to the Committee on Ways and Means, Government Printing Office, 1919, pp. 13-14; reproduced as supplement to the Corporation Trust Company's Federal Services)

[7] "Capital assets" were defined as "property acquired and held by the taxpayer for profit or investment for more than 2 years (whether or not connected with his trade or business)," but not including "property held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year."

for the income year 1918 and 73 per cent for the years 1919 and 1920. The contention that a moderate rate would encourage the sale of much property which otherwise would not be sold was one of the main arguments for the adoption of a preferential rate of tax for capital gains.[8]

The bill as introduced and reported by the Ways and Means Committee provided that in the case of individuals whose combined ordinary net income and net capital gain were in excess of $40,000, the total tax should be the amount of the tax on the ordinary net income at regular rates plus 15 per cent of the capital net gain or minus 15 per cent of the capital net loss. The bill as passed by the House substituted $29,000 for $40,000 and 12.5 per cent for 15 per cent.[9]

The Senate Finance Committee bill using a different approach substituted for the flat rate tax a provision that only 40 per cent of net capital gain (of both individuals and corporations) should be taken into account in computing the net income on which the regular income tax was to be levied. The maximum combined normal and surtax rate on ordinary income was to be 40 per cent and, thus, the maximum rate on capital net gain would be 16 per cent. This procedure, it was pointed out, would give taxpayers at all income levels benefit from special capital gains treatment. No limitation was placed on losses; hence they would be deductible from ordinary income if they exceeded capital gains.

The provision that special treatment should be allowed only with respect to gains from assets held two years or more came into the bill as an amendment offered on the floor by Senator Walsh of Massachusetts.[10]

The bill, as finally enacted, provided for the 12.5 per cent tax on capital gains but omitted the House limit on deduction of losses. Consequently, any excess of loss over gains could be offset in full (not at 12.5 per cent) against other income, a concession which immediately gave rise to criticisms. Moreover, under the "net loss" provision, losses on business assets (even if they were "capital assets") might be carried forward to offset ordinary income in succeeding years.[11]

[8] The Ways and Means Committee in commenting on the capital gains provision said: "The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the tax revenue, have been blocked by this feature of the present law." (Committee on Ways and Means, Report on Revenue Bill of 1921, House of Representatives Report No. 350, 67th Cong., 1st sess., pp. 10-11)

[9] The special rate for capital gains was placed at the level of the corporation income tax rate. (The Revenue Act of 1921 increased the corporation income tax rate from 10 per cent to 12.5 per cent at the same time that it repealed the wartime excess profits tax.) The $29,000 level was approximately the point at which the surtax rate would exceed 12.5 per cent.

[10] In opposition to the bill under consideration which proposed that preferential treatment be extended to all capital gains, Senator Walsh said, "There is no distinction made between increased value. . . extending over a long period of years and that sudden and speculative increase that develops within a short period of time." As a means of excluding speculative gains from favorable treatment, he proposed a three-year holding period. When asked if a one-year requirement would meet his objection, he stated that one year was too short, but offered to compromise on two years. (*Congressional Record*, Senate, Vol. 61, Part 7, 67th Cong., 1st sess., pp. 6575-6576)

[11] Section 204.

Another significant change in the 1921 act was designed to prevent avoidance of the capital gains tax through gifts of appreciated property to others in whose hands appreciations prior to the date of the gift were nontaxable. The 1921 law specified that when property was acquired by gift after December 31, 1920, the basis for calculating gains and losses should be the basis "in the hands of the donor or the last preceding owner by whom it was not acquired by gift" rather than the value of the property when received by the taxpayer.[12]

The section on exchanges was also expanded and liberalized.[13] Finally, the loss provision was amended by adding a "wash sale" clause denying the deduction of a loss on a security transaction where the taxpayer within thirty days before or after the sale has acquired "substantially identical property."[14]

The effect of the failure to limit the deduction of losses was soon recognized. The Secretary of the Treasury in his *Annual Report* for 1922 referred to the serious effect upon revenues and urged that a limitation be placed on losses comparable to that applicable to gains.[15]

In 1922, Mr. Ogden Mills, then a member of the Ways and Means Committee, sponsored an amendment to the Revenue Act of 1921 which provided in effect that the amount by which the income tax could be reduced by reason of capital losses should not exceed 12.5 per cent of such losses.[16] Mr. Mills emphasized the injustice to the Government of allowing full deduction of losses while taxing gains at a maximum rate of 12.5 per cent. He pointed out that under the then current rates the Government could collect but 12.5 per cent of a gain but was compelled to lighten the burden of the taxpayer to the extent of 58 per cent of his losses if he were in the top surtax bracket. No action was taken by Congress, however, until 1924.

[12] Section 202(a)(2). Prior to the 1921 act the statute contained no explicit rule for determining the gain or loss on the sale of property acquired by gift, but the Bureau of Internal Revenue had held the proper basis to be the fair market price or value of such property at the time of acquisition.

[13] Section 202(c). The Secretary of the Treasury had criticized the exchange provision on the grounds that it failed to take account of transactions in which it was difficult to determine the gain or loss in the absence of an actual sale and had urged that certain types of exchanges be exempted. The 1921 act completely rewrote the exchange provision to incorporate some of these suggestions. It provided that exchanges of property would not be taxable unless the property received in exchange had a "readily realizable market value" and in addition specificially exempted certain types of exchanges even if the property received in exchange had a readily realizable market value.

[14] Section 214(a)(5). (Now section 118, I.R.C.)

[15] After stating his recommendation, Secretary Mellon added, "The alternative is to refuse to recognize either capital gains or capital losses for income-tax purposes, and if the present situation were allowed to continue there is no doubt that it would save revenue to adopt this course. . . ." (*Annual Report* of the Secretary of the Treasury, 1922, p. 14)

[16] See Report of the Committee on Ways and Means on H.R. 13770, House Report No. 1388, 67th Cong., 4th sess., submitted January 12, 1923, by Mr. Mills. In this report, statistical evidence was presented to show that "taxpayers have not been slow to avail themselves of this means of escape." It was also pointed out that many of the alleged losses were nothing more than paper losses. Taxpayers sold securities at a loss, which was deducted from income for tax purposes, and after thirty days bought back the same securities, or immediately bought securities of a similar class of approximately the same value, and so found themselves in substantially the same position as before the sale, having in the meantime realized a loss for tax purposes. (p. 2)

Revenue Act of 1924

The Revenue Act of 1924 terminated the provision for full offset of losses against other income and limited the amount by which the tax could be reduced by such losses to 12.5 per cent of such losses.[17] The " net loss " provision was also amended to prevent any part of a capital net loss from being carried forward and applied against the income of a succeeding year.[18]

The provision in the 1921 act, that the total tax (normal and surtax on ordinary net income plus 12.5 per cent of capital net gain) could in no case be less than 12.5 per cent of the total net income, was removed.

The definition of capital net gain was revised so that the taxpayer who had a deficit in his ordinary income could offset his deficit against capital net gains. The tax in such cases would be 12.5 per cent of an amount determined by subtracting from the capital net gain the amount of the deficit in ordinary net income.[19]

The definition of " capital assets " was changed in several respects, the most important being that it was no longer required that assets must have been acquired for profit or investment.[20] The former exclusion from capital assets of " property held for the personal use or consumption of the taxpayer or his family " was eliminated. The Senate Finance Committee explained that this restriction was removed with the purpose of permitting a taxpayer selling residential property to elect to be taxed under the capital gains section.[21] Added to the exclusions from capital assets, for purposes of clarification, was " property held primarily for sale in the course of trade or business." The Senate Finance Committee stated that the purpose of this change was to make it clear that property held primarily for resale did not constitute a capital asset, regardless of

[17] Section 208(c) provided in the case of a capital net loss the tax should be the tax computed on ordinary income less 12.5 per cent of the capital net loss, but in no case could the tax be less than the the tax (computed at normal and surtax rates) would be if the capital net loss were deducted from ordinary net income. The explanation given for the latter provision was that the general purpose of the limitation was to increase the revenues by limiting deductions. Taxpayers subject to surtax rates below 12.5 per cent would find it advantageous to deduct 12.5 per cent of capital losses rather than to deduct the full amount of losses from ordinary income. This provision would prevent such taxpayers from being in a better situation under the 12.5 per cent limitation than under the prior law.

[18] The net loss provision, section 206(a)(2), provided that deductions for capital losses otherwise allowed by law should be allowed only to the extent of capital gains. In discussing this amendment to the net loss provision the Ways and Means Committee said: " Under the capital loss section a taxpayer may be liable to tax even though he has no net income. If capital losses were allowed as a deduction in computing the net loss, it would result in the anomalous situation of a taxpayer paying a tax in one year but at the same time having a net loss which he could carry over as a deduction in computing the tax for the subsequent year. For this reason and for the further reason that net losses are considered as the losses resulting from the operation of a trade or business it is provided in the bill that in computing the net loss capital losses shall be deductible only to the extent of the capital gains." (Report of the Committee on Ways and Means on the Revenue Bill of 1924, House Report No. 179, 68th Cong., 1st sess., p. 56)

[19] Section 208(a)(5).

[20] Section 208(a)(8). " Capital assets " were defined as " property held by the taxpayer for more than two years (whether or not connected with his trade or business) " but not including " stock in trade of a taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business."

[21] Report of the Senate Finance Committee on Internal Revenue Bill of 1924, Senate Report No. 398, 68th Cong., 1st sess., p. 22.

whether or not it was the type of property included in inventory under good accounting practice.[22]

Other changes were: strengthening of the "wash sale" section;[23] a provision restoring the rule first established in 1918 that liquidating dividends constitute sales of the stock;[24] and a provision designed to prevent the use of reorganizations to escape proper taxation by stepping up the basis used in calculating gains and losses from the sale of assets transferred in connection with a reorganization or by distributing as capital gains what were in effect dividends out of earnings.[25]

Revenue Acts of 1926 and 1928

The Revenue Act of 1926 made only minor changes in the capital gains provisions. The Revenue Act of 1928 rearranged and renumbered the capital gains provisions but made no important changes in them.

In 1927 the staff of the Joint Committee on Internal Revenue Taxation in its report on capital gains had recommended that the existing treatment of capital gains be retained, observing that a "fair inference may be drawn that the lowering of the rate [to 12.5 per cent by the Revenue Act of 1921] largely contributed to bring activity in the sale of property."[26] During this period the normal and surtax scale was greatly reduced and complaints began to be heard that the 12.5 per cent rate on capital gains should be correspondingly reduced.[27] No action was taken in this direction, however.

Revenue Act of 1932

Action, when it did come, in the Revenue Act of 1932, was of quite a different character. By this time the collapse of security prices had generated a vast flood of deductible losses and steps were taken to restrict further the privilege of deducting such losses in arriving at taxable income.[28] The Ways and Means Committee bill provided that gains and losses on stocks and bonds could be offset only against one another, subject also to the condition that the tax must not be less than it would be under the 12.5 per cent limitation of the existing law. The Senate Finance Committee felt, however, that the corrective action proposed by the House was too severe and recommended that the restriction be placed only on short-term transactions in stocks and bonds and that a one-year carry-over of losses be allowed to avoid hardships.[29]

[22] *Ibid.*

[23] Section 214(a)(5) was amended to provide for the disallowance of any loss "where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired . . . *or has entered into a contract or option to acquire* substantially identical property." (Italicized words were new.)

[24] Section 201(c).

[25] Section 204(a)(8).

[26] Report of the Joint Committee on Internal Revenue Taxation, November 15, 1927, Vol. I, pp. 40 and 44.

[27] The maximum combined normal and surtax rate under the Revenue Act of 1921 (which introduced the 12.5 per cent rate on capital gains) was 58 per cent. It had been reduced to 46 per cent by the Revenue Act of 1924 and to 25 per cent by the Revenue Act of 1926. For income years 1925 through 1931, 25 per cent remained the maximum combined rate (with the exception of 1929 when it was 24 per cent).

[28] The Ways and Means Committee revealed that "many taxpayers have been completely or partially eliminating from tax their income from salaries, dividends, rents, etc., by deducting therefrom losses sustained in stock and bond markets with serious effect upon the revenue." (Report of the Committee on Ways and Means on the Revenue Bill of 1932, House Report No. 708, 72nd Cong., 1st sess., pp. 12-13.)

[29] Report of Senate Finance Committee on the Revenue Bill of 1932, Senate Report No. 665, 72nd Cong., 1st sess., p. 10. The Senate Committee argued that losses from securities held for more

The bill as finally enacted followed the lines of the Senate Finance Committee's recommendations. It provided that losses of both individuals and corporations on transactions in stocks and bonds held less than two years should be allowed "only to the extent of the gains from such sales or exchanges." [30] It also specified that losses so disallowed might be carried forward to an amount not in excess of the taxpayer's net income for the taxable year, and offset against gains from such sales in the succeeding taxable year,[31] but this privilege was destined to be nullified before it went into effect by the National Industrial Recovery Act.[32] The latter act also amended the 1932 law to prevent partners from deducting in their personal returns for their shares of partnership losses on short-term transactions.[33]

THIRD PERIOD: THE STEP-SCALE PLAN, 1934-1938

Revenue Act of 1934

The Revenue Act of 1934 provided for the most comprehensive redrafting of the capital gains and loss provisions of the income tax since 1921.

Public interest in the taxation of capital gains had been greatly stimulated by the sensational treatment in the press of testimony in the hearings before the Senate Committee on Banking and Currency on stock exchange practices in 1933. This testimony concerned wealthy individuals who had paid no income taxes over a period of several years in the early 'thirties because deductions of losses from the sales of stocks and bonds wholly offset ordinary income. The Revenue Act of 1932 had already limited the reduction of ordinary net income by providing that losses from sales of stocks and bonds held two years or less could be taken only to the extent of gains from similar sales.

Possible changes in the method of taxing capital gains were considered by a subcommittee of the Committee on Ways and Means, which was organized previous to the convening of Congress in December, 1933, to investigate, among other things, methods of preventing tax avoidance.[34] The staff of the Joint Committee on Internal Revenue Taxation placed before this subcommittee a memorandum which summarized the criticisms of the existing law and suggested a new plan of taxing capital gains according to the length of time the assets had been held.[35] The subcommittee adopted the suggested plan, and the Congress enacted a modification of it into law as a part of the Revenue Act of 1934.

The report of the staff of the Joint Committee criticized the existing method of taxing capital gains, particularly for its failure to give tax benefit to all taxpayers with capital gains and its failure to differentiate among gains held for different periods

than two years are real losses and that the existing 12.5 per cent limitation on losses was adequate protection against excessive deductions.

[30] Section 23 (r) (1). Through the application to corporations of these restrictions on loss deductions, special treatment was first extended to sales and exchanges of capital assets of corporations.

[31] Section 23 (r) (2).

[32] 48 Stat. 195 (chap. 90) 218 (b).

[33] Section 218 (d) of NIRA.

[34] See "Prevention of Tax Avoidance," Preliminary Report of a Subcommittee of the Committee on Ways and Means, 73d Cong., 2d sess., House Committee Print, 1933.

[35] *Ibid.*, p. 36.

of time.[36] The two-year holding-period requirement for preferential treatment was criticized on the grounds that it encouraged taxpayers to postpone taking gains until the two-year period expired in order to reduce their taxes and stimulated the taking of losses within the two-year period in order to get full benefit from them.

Starting with the assumption that the fundamental difference between income from capital gains and ordinary income lies in the element of the time of realization, the report of the Joint Committee's staff concluded that an equitable method of taxing capital gains would be one under which the tax would approximate that which would have been paid if the gain had been realized in equal annual amounts over the period for which the asset was held. In an attempt to achieve this objective, a plan was developed under which capital assets were divided into several classes according to the length of time the asset had been held by the taxpayer, with a declining percentage of the gain or loss included in ordinary income (subject to full normal and surtax rates) as the holding period increased. If losses taken into account exceeded gains, the excess losses could not be deducted from other income. This restriction of the deductibility of losses on transactions in property to gains from similar transactions was an extension of the limitation introduced in the 1932 law with respect to short-term transactions in stocks and bonds.

In the hearings before the Ways and Means Committee in December, 1933, Mr. Roswell Magill, representing the Treasury Department, criticized the subcommittee's step-scale plan of inclusion (with percentages ranging from 100 per cent for assets held one year or less to 20 per cent for assets held five years or more) on the grounds that it would put a premium on holding appreciated assets five years, in which case only 20 per cent of the profit would be recognized, and thus would put an even greater brake upon the sale of appreciated capital assets than was the case under existing law. Moreover, he pointed out that although the part of the gain recognized was subject to ordinary normal and surtax rates, the effective rate of tax upon the actual gain would be very low after the fifth year, in fact, lower than 12.5 per cent in every bracket but the highest. Concerning the intent of the step-scale plan to approximate the tax which would have been paid if the gain had been realized in equal annual amounts, he pointed out that a taxpayer selling a six-year investment at a $60,000 profit under the plan would be taxed on 20 per cent of the profit or $12,000 at current rates while in fact he had a gain accruing at the average rate of $10,000 per year for six years and might reasonably be subjected to six taxes on an item of $10,000, instead of a single tax on $12,000 as proposed. He also called attention to the fact that a loss on property held one year only, under the plan, would completely wipe

[36] The report pointed out that under existing income tax rates the 12.5 per cent rate limitation gave relief only to taxpayers with surtax net incomes of over $16,000. An earlier report of the Joint Committee's staff ("Supplemental Report on Capital Gains and Losses, submitted November 26, 1928, and published June 8, 1929) had pointed out that under the income tax rates then in effect (Revenue Acts of 1926 and 1928) the 12.5 per cent rate gave no relief to 98.5 per cent of the approximately 4,000,000 persons filing income tax returns and gave substantial benefit to less than 10,000 taxpayers, or one-fourth of 1 per cent of them.

out a gain five times as large on property held more than five years.[37]

Speaking for the Treasury, Mr. Magill suggested two alternatives to the subcommittee plan. Both continued the distinction between transactions within a two-year period and those covering a longer period and both continued to treat short-term gains as ordinary income. The first would have provided a flat rate tax on capital net gains as under the then existing law but permitted the deduction of capital losses only from capital gains, with perhaps a carry-forward of losses for one year. The second would have segregated gains and losses as before and limited deductions of losses to the extent of gains. It would then have adopted the general principle proposed by the subcommittee but with a different method of implementation so as to make the resulting tax, insofar as possible, approximately the same as the total taxes would have been if the capital gain were spread over the period during which the assets were held.[38] He offered no specific suggestions, however, as to how this result might be achieved.

Both the Ways and Means and Senate Finance Committees concurred in the general features of the subcommittee's step-scale plan, but each made adjustments in the classes of assets and percentages of inclusion applicable to the classes. The bill as finally enacted incorporated the scales set up in the Senate bill.

The most important feature of the 1934 act was the entirely new section 117 entitled "capital gains and losses" which incorporated the new plan with the following steps:

Period assets held	*Percentages of gain included in ordinary income*
1 year or less	100
Over 1 year but not over 2 years	80
Over 2 years but not over 5 years	60
Over 5 years but not over 10 years	40
Over 10 years	30

Another revision made by the Senate was also included in the act as finally approved. The general limitation that capital losses should be allowed only to the extent of capital gains was modified by the provision that $2,000 of such excess losses could be charged against ordinary income. This provision, it was explained, was intended to protect the small taxpayer with infrequent capital transactions.

The loss limitation applied to net capital losses of corporations as well as of individuals. However, the graduated percentage reduction of gains and losses to be included in ordinary income did not apply to corporations.

The definition of "capital assets" was revised by inserting the words "to customers" in the exclusion from capital assets of "property held by the taxpayer primarily for sale *to customers* in the ordinary course of his trade or business."[39] Another provision, intended to close a tax avoidance loophole, prohibited deduction of losses on property transactions between members of a family and between an individual

[37] Hearings of the Committee on Ways and Means on Revenue Revision, 1934, pp. 39-40.

[38] *Ibid.*, p. 40.

[39] The effect of adding the words "to customers" was to make a "trader" in securities (one who buys and sells on his own account) subject to the capital gain and loss provisions. Under prior law it had been held that a "trader" in securities, although not a "dealer" in securities, was nevertheless engaged in a trade or business and that, therefore, the capital gain and loss provisions did not apply. The stated purpose of this change was to prevent tax avoidance through unlimited deductibility of losses by the stock speculator trading on his own account.

and a corporation in which the individual owned more than half the stock.[40]

A new rule was adopted concerning the basis for determining gain or loss in the case of gifts made after December 31, 1920. The previous rule had been that a taxpayer acquiring property by gift was required to use as his basis the basis the property had in the hands of the donor (or the last preceding owner by whom it was not acquired by gift). The new rule provided that in computing losses the fair market value at the time of the gift should be substituted whenever that figure was lower than the donor's basis.[41]

FOURTH PERIOD: COMBINATION OF PERCENTAGE INCLUSION AND FLAT RATE TAX, 1938 TO PRESENT

Revenue Act of 1938

The subcommittee of the Ways and Means Committee which was appointed in August, 1937, to consider possible changes of the Federal revenue laws devoted considerable attention to the taxation of capital gains.[42] In its report, submitted in January, 1938, the subcommittee concluded that taxation of capital gains is justified on the grounds that (1) capital gains represent taxpaying ability no less than equivalent income from other sources and repeal of the capital gains tax would increase the tax burden on other income; (2) the great bulk of capital gains are realized in connection with transactions entered into for profit; and (3) complete exemption of capital gains from income taxes would permit tax avoidance through conversion of other types of income into capital gains.[43]

The objections to the then existing method of taxing capital gains led the subcommittee to consider various other methods. One of these, the average annual accrual method, would average separately over the number of years the assets were held the gains and losses realized and would tax such average annual amounts when added to or subtracted from ordinary income at the current tax rates. The increment of tax resulting from the average gain and the tax credit on the average loss would be multiplied by the average number of years the assets were held, and the sum of the products would represent the tax. The subcommittee rejected this plan as too complex. Other methods considered and rejected by the subcommittee included (1) the complete segregation of capital gains and losses from other sources of income and separate taxation; (2) the averaging of capital gains together with ordinary income for several years; and (3) the inclusion in taxable income of annually accrued though unrealized gains and losses. The reasons given for rejecting these methods were: the first partially ignores the ability-to-pay principle; the second might require the taxpayer to pay taxes upon an average income higher than his current income; while the third, apart from constitutional difficulties, involves an insurmountable problem of valuation and an enforced

40 Section 24(a)(6).

41 Section 113(a)(2). The previous rule had proved unsatisfactory because it made possible the transfer of losses from one person who had insufficient income to take advantage of the loss to a relative or close friend who had a large enough income against which to offset the entire loss.

42 See Report of Subcommittee of the Committee on Ways and Means on Proposed Revision of the Revenue Laws, 1938.

43 *Ibid.*, p. 30.

accounting for profits and losses prior to realization.

The subcommittee, after an examination of the criticisms which had been offered of the existing method of taxing capital gains, decided to preserve the essential features of the plan adopted in the Revenue Act of 1934 but to take measures to remove some of the causes of complaint.

The most persistent objection to the capital gains tax was that it interfered with transactions in securities and other capital assets and accentuated booms and collapses. The sharp step-downs in the percentage of gain or loss to be taken into account were alleged to encourage taxpayers to delay taking gains and to stimulate them to realize losses.[44] The subcommittee stated that the available evidence and analysis did not support the charge that the capital gains tax interfered with transactions and accentuated booms and collapses. It expressed the opinion that the underlying business situation and the related speculative temper of the times were primarily responsible for stock market and real estate booms and collapses.

The subcommittee admitted, however, that whatever effect the capital gains tax had on the capital markets was accentuated by the wide spread in the step-down percentages of the existing law. It recommended, therefore, a modification of these percentages. Net capital gains from sale or exchange of assets held one year or less would be fully taxed, as under the Revenue Act of 1934, at rates provided for other income. With respect to assets held more than one year, the percentage of gain or loss to be taken into account would decline on a monthly, rather than an annual basis, by 2 per cent per month for each full month the asset was held in the second year and by 1 per cent a month thereafter to a minimum of 40 per cent inclusion at the end of the fifth year. This more gradual step-down was intended to eliminate the tax inducement to concentrate transactions at certain time periods, with the accompanying accentuations of rises or declines in asset values.

The 1934 capital gains provisions had been criticized on the grounds that the tax was so high, especially in the case of taxpayers in the high surtax brackets, that assets became frozen and few transactions took place. It was argued that elimination of the high rates would accelerate liquidation of large blocks of overpriced securities and give added mobility to the capital funds markets, as well as encourage investment in new enterprises. To meet this objection, the subcommittee felt it would be desirable to fix a maximum rate of tax for gains on assets held more than one year. It therefore recommended the reintroduction of the alternative flat rate tax. As a result of the step-down percentages of inclusion of gain or loss, the effective rate of tax upon the actual gain realized would range from a maximum of 40 per cent where the asset had been held for a period slightly in excess of one year to a minimum of 16 per cent if the asset had been held for more than five years. This provision, it was believed, would increase the certainty of the rate of tax applicable to large capital gains and, since the rate imposed was considerably less than that imposed on ordinary income, would meet the objection that high rates were preventing the sales of assets.

44 Proposed Revision of the Revenue Laws, 1938, *op. cit.*, p. 29.

A principal objection to the then existing method of taxing capital gains was that capital losses, after application of the statutory percentages, were not fully deductible, but were allowed only to the extent of the recognized capital gains, plus $2,000, with no carry-forward of losses. It was contended that much of the incentive for investing capital in new enterprises was removed by the prospect that a large part of the gains, if any, would be taken by taxes, while the losses, if any, would be allowed only in part as a deduction against taxable income.

The subcommittee expressed the view that the principle adopted in the Revenue Act of 1934 of denying the privilege of using capital net loss as an offset against ordinary income (except to the limited extent of $2,000) should be kept as a "necessary and salutary safeguard of the income-tax revenue."[45] Furthermore, it recommended that the privilege of using short-term capital losses to offset long-term capital gains should be removed to prevent the use of short-term speculative losses to wipe out long-term investment gains.[46] This was to be accomplished through the complete segregation of short-term and long-term gains and losses. In defense of segregation, the subcommittee pointed out that the settled policy of Congress had been to tax speculative gains in general in the same manner and to the same extent as earned income and business income. On the other hand, special treatment had been given to long-term capital gains. Although admitting that a classification based solely upon the period of holding is not an exact method for segregating speculative from investment transactions, the subcommittee indicated that this appeared to be the only practicable method and a sufficiently fair criterion for practical purposes.

The subcommittee recognized that some hardships and inequities result from the placing of limitations on the deduction of capital losses but pointed out that these arise in part from the fact that capital gains and losses, like other income, are computed on an annual basis, as a result of which an individual may be required to pay a heavy tax on a large capital net gain in a given year despite the fact that in the preceding year he sustained a heavy capital net loss from which he derived no tax benefit. Some method of minimizing these hardships without seriously reducing revenues or reopening loopholes for evasion of the tax was sought. After consideration of various alternatives, the subcommittee decided upon the allowance of a one-year carry-over of net capital losses, subject to certain limitations. In order to adhere to the principle of segregation, it was recommended that distinct carry-overs be provided for net capital losses in each category. In the case of short-term losses, it was proposed that the carry-over should not exceed the net income of the taxable year in which the loss was realized. The carry-over of net long-term capital loss, however, would not be limited in terms of the individ-

[45] Subcommittee Report, p. 39.

[46] The Ways and Means Committee in adopting this recommendation pointed out that statistics presented to the committee showed that 85 per cent of all capital gains and losses arose from transactions involving securities and that approximately 35 per cent of the total transactions in securitiees fell into the short-term category. Such transactions were considered predominantly speculative in character. (Committee on Ways and Means Report on Revenue Bill of 1938, House Report No. 1860, 75th Cong., 3d sess., p. 7)

ual's net income in the year in which the net loss was realized. The subcommittee justified this difference of treatment on the grounds that transactions included in the long-term category are predominantly investment rather than speculative in character and it was the policy to minimize the adverse effects of the capital gains tax upon the free flow of capital funds into productive enterprises.

The bill as approved by the House followed closely the recommendations of the subcommittee. The Senate bill's treatment of short-term gains and losses was identical with the House bill except that the holding period was eighteen months instead of one year. The treatment of long-term gains and losses, however, was entirely different. The step-scale plan of percentage inclusion proposed by the House was rejected as too complex and the several percentage brackets of the 1934 act were eliminated. The general rule was laid down that in the case of long-term assets (held over eighteen months) 50 per cent of such gains or losses would be included in computing net income. An alternative tax with a maximum rate of 15 per cent was provided. The taxpayer either could include 50 per cent of the net long-term capital gain in his income subject to the regular normal and surtax rates or could segregate his long-term gains and pay a tax of 15 per cent on the total net long-term gain, whichever resulted in the lesser tax. Consistent treatment was provided in the case of net long-term capital loss. The taxpayer either could deduct 50 per cent of the net long-term loss from his other income or could credit 15 per cent of the total net long-term capital loss against the tax on his other income, whichever method resulted in the greater tax. No carry-over of long-term losses was to be allowed on the grounds that they were allowed against ordinary income.

The act as finally approved retained two classes of long-term assets, those held more than eighteen but not over twenty-four months (with 66⅔ per cent inclusion) and those held over twenty-four months (with 50 per cent inclusion).

The alternative tax was adopted. Net long-term gain, determined on the basis of the appropriate percentages, either could be included with other income subject to normal and surtax rates or taxed separately at 30 per cent, whichever resulted in the lesser tax. When account was taken of the percentage inclusion, the maximum effective rate was thus 20 per cent with respect to gains on assets held over eighteen but not over twenty-four months, and 15 per cent with respect to gains on assets held over twenty-four months. Similarly, net long-term capital loss (determined on the basis of the appropriate percentage) either could be deducted from other income (including net short-term gain) or 30 per cent of the loss could be credited against the tax on other income, whichever method resulted in the greater tax. No long-term loss carry-over was allowed.

The 1938 plan of taxing capital gains was thus in part a continuation of the 1934 system of percentage inclusion of capital gains and losses and in part a reversion to the pre-1934 flat rate tax in case of gains and flat rate reduction in tax in case of losses.

An important change in the definition of "capital assets" was made by the Revenue Act of 1938. Depreciable property used in trade or business was

added to the classes of goods not constituting capital assets. The need for this amendment was traceable in large part to the limitation placed on corporate losses by the 1934 Revenue Act. Under that act, the $2,000 limitation had been placed on the amount of corporation capital losses which could be deducted from ordinary income. This limitation was considered particularly unfair in the case of depreciable property such as machinery, plant, and equipment used in the trade or business. Primarily to take care of this situation, the 1938 act provided for full deduction of losses on sales of depreciable property used in the trade or business by excluding such property from the definition of capital assets.

The subcommittee of the Committee on Ways and Means, appointed in August, 1937, to consider tax revision, had recommended this change on the ground that "gains or losses realized upon the sale, exchange, or other disposition of such property are business gains or losses and directly affect the volume of the business profit which should be subjected to tax in the years in which such transactions occur."[47] The subcommittee pointed out that the result of treating losses from sale of depreciable property as capital losses, not fully allowable, was that taxpayers either continued to use "a less efficient and uneconomical machine" until its full cost had been recovered through the depreciation allowance or else, instead of selling on the open market, junked the old machine and thereby increased the amount of the loss for which a full deduction would be claimed on the basis of the alleged obsolescence. In adopting the subcommittee's recommendation, the Ways and Means Committee referred to it as a relief provision and stressed the advantage to the taxpayer of being able to charge off against ordinary income the full amount of losses from sales of depreciable property.[48]

The Revenue Act of 1938 also revised the treatment of losses sustained on worthless securities by providing that such losses should be considered as losses from the sale or exchange of capital assets.[49] This provision was designed to remove the distinction made under existing law between taxpayers who held on to worthless securities and those who sold them. Losses sustained by reason of securities having become worthless were permitted to be deducted in full from gross income[50] whereas losses resulting from the sale or exchange of such securities were subject to limitations under the capital gains provisions.

Revenue Acts of 1939 and 1940

The Revenue Act of 1939 made an important change in the treatment of capital losses of corporations. For the first time a distinction was made between short- and long-term capital losses of corporations. Long-term losses (from assets held eighteen months or more) were made fully deductible under the income tax while short-term losses were to be subject to the same limitations that were then applied (under the Revenue Act of 1938) to individuals, that is, short-term losses could be offset only against short-term

[47] *Proposed Revision of the Revenue Laws*, 1938, *op. cit.*, p. 34.

[48] Committee on Ways and Means Report on the Revenue Bill of 1938, House Report No. 1860, pp. 6-7, 34-35.

[49] Section 23 (k) (2).

[50] Under section 23 (e) or (f) as losses, or under section 23 (k) as bad debts.

gains and a one-year carry-over of the excess of losses was allowed but only to the extent of the ordinary income of the year of the net short-term loss. Both long-term and short-term net capital gains of corporations, however, were to continue to be included in ordinary income and subject to regular income tax rates.

The 1939 Revenue Act, by making long-term capital losses of corporations fully deductible under the income tax, took care in part of a problem which had arisen as a result of the exclusion of depreciable property from capital assets under the 1938 act. As a result of the 1938 change, buildings and other depreciable real estate improvements attached to the land were excluded from capital assets while land continued to be treated as a capital asset. Unruly administrative problems with respect to allocation of the sale price between land and improvements arose from this nonuniform classification. The 1939 act, by making long-term capital losses of corporations fully deductible under the income tax eliminated the necessity, insofar as corporations were concerned, of allocating losses between depreciable and nondepreciable property.[51]

Under the excess profits tax, enacted in 1940, long-term capital gains and losses were excluded in computing excess profits net income. Also net gains from the sale or exchange of depreciable assets held more than eighteen months were excluded from excess profits net income although net losses were deductible in full.[52] Short-term gains and losses of corporations were given the same treatment for purposes of the excess profits tax as under the income tax.[53]

Revenue Act of 1941

The Revenue Act of 1941 amended the definition of " capital assets " to exclude certain short-term Federal, state, and local government obligations issued on a discount basis after March 1, 1941. This amendment which applied primarily to Treasury bills of the United States provided that the issuing discount on such obligations should not be deemed to accrue until the obligations are paid at maturity or disposed of, and that such obligations should not be treated as capital assets. The principal effect of this amendment was to eliminate the necessity (except in the case of life insurance companies) of making an allocation between the interest and capital gain or loss on the disposition of the obligation and also the necessity for including any portion of the discount in income for any taxable year until that in which the obligation matures or is disposed of.[53a]

[51] In explanation of the 1939 revision the Ways and Means Committee said: " Your committee's proposal will remove a tax irritant which has handicapped many corporations. It will have the effect, in general, of placing corporations more nearly on a parity with individuals with respect to capital losses. By the removal of the $2,000 limitation, the necessity of allocating losses between depreciable and nondepreciable property will be eliminated." (Report of the Committee on Ways and Means on the Revenue Bill of 1939, 76th Cong., 1st sess., p. 11)

[52] This latter provision was replaced by section 117(j) of the 1942 Revenue Act which had the same effect on gains and losses from such holdings. Under the 1942 Revenue Act (sec. 208) the excess of gains over losses from involuntary conversions of depreciable property held more than eighteen months was also excluded retroactively from the excess profits net income for 1940 and 1941.

[53] That is, net short-term gain was included in income and fully subject to tax and short-term loss was allowed only to the extent of short-term gain but with a one-year carry-over (to an amount not in excess of net income).

[53a] Conference Report on the Revenue Bill of 1941, 77th Cong., 1st sess., House Report No. 1203, p. 11; also Senate Committee on Finance, Report on the Revenue Bill of 1941, Senate Report No. 673, Part 1, pp. 30-31.

Revenue Act of 1942

The Revenue Act of 1942, the first revenue act of World War II, sharply increased income taxes on individuals and corporations. Through the lowering of personal exemptions and the introduction of the Victory tax, it broadened the individual income tax base and made millions of individuals subject to income tax for the first time. In this setting of wartime tax increases, treatment of capital gains and losses was reviewed and significant changes were made. Major revisions included a moderate increase in the maximum rate applicable to long-term capital gains, a drastic shortening of the holding period for long-term gains, and a limitation of the extent to which losses could be offset against ordinary income. Offsetting the latter limitation was a provision for merging of short- and long-term losses and allowance of a five-year carry-over of the excess of capital losses. The treatment of gains and losses on property used in the trade or business also was further liberalized.

A major issue considered by the Congressional committees in their review of the capital gains provisions was whether it was desirable to retain the distinction between short- and long-term transactions and, if so, where the line of demarcation should be drawn. The Treasury in its recommendations to the Ways and Means Committee suggested that the two classes of long-term assets set up under the Revenue Act of 1938 be replaced by one, including all assets held more than eighteen months, gains from which would be included in income to the extent of 50 per cent. This simplification and shortening of the holding period, it was suggested, would minimize the influence of tax considerations on the timing of sales.[54] The Ways and Means Committee approved substituting one class of long-term assets for the two, but drew the line between short- and long-term gains at fifteen months instead of eighteen months.

During the discussion of the revenue bill in the House, lengthy consideration was given to H.R. 6358 (77th Cong., 2d sess.), the Boland bill, which would have eliminated the distinction between short- and long-term gains and losses and would have completely segregated capital gains and losses from other income and taxed net capital gains at a flat rate of 10 per cent for both individuals and corporations. In connection with this proposal, arguments were offered that the distinction between long-term and short-term gains was artificial and unsound and that, therefore, the holding period should be eliminated entirely as the worst feature of the capital gains tax because it interfered with investment and the free flow of capital and reduced tax revenue by preventing transactions.[55] Particular objection was made to the existing holding period on the grounds that it was longer than required to separate speculation from investment. The use of six months as a measure of speculative transactions was brought up in the

[54] Statement of Randolph E. Paul on capital gains and losses before the Committee on Ways and Means, May 21, 1942.

[55] See, for example, the statement of Elisha Friedman, consulting economist, Hearings before the Committee on Ways and Means on Revenue Revision of 1942, Vol. I, p. 943; and the statement of Emil Schram, President of the New York Stock Exchange, in Hearings before the Senate Committee on Finance on H.R. 7378, 77th Cong., 2d sess. Vol. I, p. 1187.

Senate hearings.[56] The provision in the SEC Act relating to trading in company stock by officers and principal stockholders, which set a six months' limit as the measure of a speculative turn, was cited as precedent, and it was argued that if six months was a measure of what constituted a speculative turn for SEC it was a good measure for the Treasury.[57]

The Senate Finance Committee adopted the six months' provision. In justification of this drastic change, the committee stated that the realization of a capital gain is entirely a matter within the discretion of the taxpayer and shortening of the holding period would have the effect of encouraging the realization of capital gains and thereby result in added revenue to the Treasury. In answer to the contention that lowering the holding period would encourage speculation, the committee expressed the opinion that a holding period of six months would be a sufficient deterrent to the speculator as contrasted with the legitimate investor.[58]

The holding-period provision constituted the major point of difference between the House and Senate bills. The conference committee approved the Senate's version—the six months' provision.

Another issue under consideration was whether the alternative rate on capital gains should be increased. The Treasury recommended that the maximum rate on statutory net capital gains be increased to 60 per cent (effective rate of 30 per cent, since only 50 per cent of such gains would be taken into account).[59] It was pointed out that the capital gains rate had been left at 1938 levels while rates on other income had been substantially increased and further increases were being proposed for the 1942 act. The suggested increase was intended to bring the tax on long-term capital gains into closer harmony with the suggested increased rates on other income.[60]

The Ways and Means Committee approved an increase of the rate to 50 per cent (effective rate of 25 per cent). In its report on the bill, the Committee said in justification of this increase:

> ... since the rates of tax on individuals have been increased drastically so far as wages and other fixed or determinable income is concerned, it is believed only proper that some additional tax should be derived in this emergency from capital gains. However, your committee realizes that since the realization of a capital gain is solely a matter within the discretion of the taxpayer, a too high capital-gain tax rate will lose rather than gain revenue for the Government. With a top normal and surtax rate of 88 percent, it is not believed that a moderate increase in the capital-gain rate will retard capital transactions.[61]

[56] During the hearings Senator Taft inquired of Mr. Schram whether he thought reducing the limit to about six months would cover activities of speculators. Mr. Schram said he thought it would be very helpful but he felt that complete elimination of the holding period would be better for the revenue. Hearings of Senate Committee on Finance, Vol. I, p. 1189.

[57] This argument for a six months' holding period had been offered by Elisha Friedman in 1938. Hearings before the Senate Committee on Finance on the Revenue Act of 1938, p. 254.

[58] Report of the Senate Committee on Finance on the Revenue Bill of 1942, 77th Cong., 2d sess., Senate Report No. 1631, p. 50.

[59] The maximum effective rate then in effect was 15 per cent on gains from assets held over two years and 20 per cent on gains from assets held over eighteen months and not over twenty-four months.

[60] Statement of Randolph E. Paul, Hearings of the Committee on Ways and Means, Vol. I, pp. 85-86.

[61] Report of the Ways and Means Committee on the Revenue Bill of 1942, House Report No. 2333, 77th Cong., 2d sess., p. 30.

The Ways and Means Committee bill also provided for the first time that corporations be allowed an alternative rate (25 per cent) on net long-term gains. The committee explained that this action was taken because of the increase in corporate taxes.[62]

Objections to an increase in the capital gains rate were voiced by various individuals who testified before the Congressional hearings on the revenue bill. Opponents of the rate increase contended that under a low rate the volume of transactions, and consequently the revenue, would be much greater than under a higher rate. It was also argued that higher rates on other income do not justify higher rates on capital gains since the latter are not income and are realized only at the choice of the taxpayer.[63] The Senate made no changes in the rate provisions contained in the House bill.

The provisions governing capital loss offsets were greatly changed by the Revenue Act of 1942. The Ways and Means Committee in reporting on the Revenue Bill of 1942 indicated that the existing law " by permitting taxpayers to deduct capital losses from ordinary income, has encouraged many taxpayers to realize capital losses and thus reduce their income tax." [64] Consequently, the committee proposed that capital losses of individuals (whether short- or long-term) be deductible only to the extent of capital gains except that the excess of losses over gains could be applied against ordinary income to a maximum of $1,000 in any taxable year. The $1,000 provision was intended to prevent hardship in the case of taxpayers having small income and sporadic losses. To compensate for the policy of offsetting capital losses only against capital gains a long carry-over period was provided. Net capital losses could be carried forward for five years against future capital gains and also up to the $1,000 maximum in each year against other income. The maximum which could be offset against ordinary income would thus be $6,000.[65] If there were carry-overs from more than one year, the carry-overs would be allowed in the order in which they arose, that is, the older carry-over would be offset before the later carry-over. The Ways and Means Committee explained that the five-year period for the carry-over would minimize the likelihood of a complete disallowance of loss and would be as long a period as is administratively feasible.[66] The Senate made no change in the loss-offset provisions.

The treatment of capital gains and losses of corporations was also revised by the Revenue Act of 1942. Long-term losses of corporations could no longer be applied against ordinary income. As in the case of individuals, short- and long-term losses would be merged and offset against capital gains (whether long- or short-term). Unlike individuals, however, corporations would be required to take into account 100 per cent of gain and 100 per cent of the loss realized on long-term assets, and would not be allowed to apply any

[62] *Ibid.*, p. 94.

[63] See, for example, the testimony of Emil Schram, President of the New York Stock Exchange; W. J. Schieffelin, Jr., Chamber of Commerce of the State of New York; Elisha Friedman, consulting economist. (Hearings before the Senate Committee on Finance on the Revenue Act of 1942, 77th Cong., 2d sess.)

[64] Report, p. 30.

[65] In effect, $12,000 of long-term capital loss.

[66] Committee Report, p. 31.

excess of capital losses over capital gains against their ordinary income.[67] As in the case of individuals, the excess of losses could be carried over as a short-term loss for five years.

The Revenue Act of 1942 amended the definition of capital assets to exclude " real property used in the trade or business." The Ways and Means Committee had proposed that uniformity of classification of land and real estate improvements be brought about by restoring depreciable real estate improvements to capital asset status. It was pointed out that the 1938 provision for treating depreciable property as a noncapital asset was inserted primarily to allow as ordinary deductions losses from sales of superseded machinery. Buildings and similar real estate improvements were in nowise connected with the purposes of the provision. The different treatment of land and real estate improvements resulted in discrimination between portions of the sale price of a single piece of property; the allocation of sales price between land and improvements involved great uncertainty for the taxpayer; and, in the case of individuals, gainful transactions were prevented both by this uncertainty and by application of progressive income tax rates rather than capital gains rates to the portion of the profit ascribed to the building. The Senate Finance Committee, however, chose to achieve uniformity by retaining the existing treatment of depreciable real property as noncapital assets and in addition making land and any nondepreciable improvements used in the trade or business a noncapital asset. In conference on the 1942 bill, the Senate amendments prevailed and " real property used in the trade or business of the taxpayer " was excluded from the definition of capital assets.

The effect of this classification was modified, however, by the new section 117(j) which provided that gains upon sales or exchanges of property used in the trade or business and recognized gains from compulsory or involuntary conversion of long-term assets should be treated as capital gains, but losses to the extent that they exceeded the gains, should be treated as ordinary losses.[68] Under this section full taxation of net gain from sale of real property would be avoided.

Section 117(j), originally formulated to apply only to involuntary conversions, had been extended during the development of the 1942 act to ordinary sales and exchanges of depreciable property and finally to real property used in the trade or business, whether depreciable or not. The Ways and Means

[67] Special treatment was provided banks since bonds are a necessary type of investment for them. Net capital losses attributable to sales or exchanges of bonds or other evidences of indebtedness would be allowed in full against other income, the capital loss to be measured by the difference between the purchase price (or amortized value) and the selling price. Losses from other types of capital assets and all gains would be treated the same for banks as for other corporate taxpayers.

[68] Prior to 1942 the mere fact that a conversion of property was involuntary did not affect the character of any gain or loss recognized on the transaction. If the conversion did not involve a sale or exchange but simply the destruction or loss of the property, as by fire, wreck, or theft, the recognized gain or loss was fully included in net income. If, however, a sale or exchange was involved, as in the case of condemnation of property by right of eminent domain, the gain or loss recognized was accorded capital gain or loss treatment unless the asset in question was not a capital asset. The classification of depreciable business property as a noncapital asset in 1938 meant that any recognized gain resulting from involuntary conversion of such property became fully taxable whether or not a sale or exchange was involved.

Committee bill limited special treatment to involuntary conversions and depreciable assets other than buildings and similar real estate improvements. The increase in involuntary conversions during the war, chiefly through shipping losses and condemnation of property for military purposes, had brought up the problem of providing special treatment for involuntary conversions. The expansion of the provision to cover ordinary sales and exchanges of depreciable property used in trade or business was intended to offer a solution to problems raised by sales under wartime conditions. The 1938 exclusion of depreciable property from capital gains treatment had been intended to give full loss offset to sales of machinery and equipment used in trade or business. In ordinary times, no gains are realized upon such sales, but because of the war situation many taxpayers were selling buildings, machinery, and other equipment at substantial gains. Many of these sales involved an involuntary element. In considering the types of property to which section 117(j) should be extended on voluntary sale or exchange, the troublesome distinction between real property and depreciable property reappeared. The Senate bill in line with the view that uniform treatment should apply to both types of business property extended the section to cover not only depreciable property but also real property used in the trade or business. In addition, the lenient treatment thus provided for gains removed a principal objection to the Senate classification of real property as a noncapital asset, namely tax interference with gainful sales. The Senate version was adopted.

Revenue Act of 1943

The treatment provided under section 117(j) was extended by the Revenue Act of 1943 to include dealings in timber [section 117(k)]. Taxpayers owning timber, or having the contract right to cut timber from the property of another, are permitted to elect to treat income from the cutting of timber in any taxable year as a capital gain rather than as ordinary income. The same treatment is also granted to a timber owner who disposes of timber under a contract by virtue of which he retains an economic interest in the timber. Gain or loss from these types of transactions with respect to the cutting of timber are considered together with gains or losses treated under section 117(j).

Revenue Acts Since 1943

The provisions governing rates, holding period, and losses which were established by the Revenue Act of 1942 continue unchanged through the Revenue Act of 1948. Although the provisions applicable to capital gains and losses have not been changed, revisions of the individual income tax rates since 1942 have altered the income levels at which the alternative tax applicable to long-term capital gains becomes effective. These levels since 1938 have varied from a high of $44,000 to a low of $12,000.[69] At present, under the Revenue Act of 1948, the alternative rate on capital gains is available only to surtax net incomes of $22,000 or more for a single person or a married person filing a separate return, and to surtax net incomes of $44,000 or more for a married person filing a joint return.

[69] The level was $44,000 for 1939, $22,000 for 1940, $12,000 for 1941, $18,000, for 1942 and 1943, $16,000 for 1944 and 1945, and $18,000 for 1946 and 1947.

THE U. S. TAX TREATY PROGRAM

MAX J. WASSERMAN and JAMES F. TUCKER *

THERE are two means of avoiding international double taxation and tax evasion. The first, a unilateral method, consists in providing, in a nation's tax laws, for exemptions and credits for foreign taxes paid, together with clauses which make evasion more difficult. The second, a bilateral method, utilizes treaties and protocols to eliminate the causes of international double taxation arising from differences in definitions and administration and to provide for administrative assistance against tax evasion. Neither method provides a complete solution to the problems; the two are complementary.

The Internal Revenue Code and International Double Taxation

In the United States the Internal Revenue Code attempts to grant relief from double taxation in sections 109, 116(a), 131, 251, and 262.

In general, the Internal Revenue Code seeks to avoid international double taxation by permitting American taxpayers to take a credit against their Federal tax liability for income taxes paid to the foreign country in which such income originates. The credit for taxes paid to a foreign country is limited to that percentage of the tax otherwise due the United States which the income derived from that country bears to the total income. It is restricted by the further limitation that this credit for all foreign taxes cannot exceed the percentage of the tax otherwise due the United States which all foreign income bears to total income. In the case of aliens resident in the United States, there is a requirement for reciprocity. In order for the alien resident to receive credit, the country of which he is a citizen must allow Americans a credit similar to that accorded alien residents in the United States.

In the case of corporations, the Internal Revenue Code also permits a credit against the Federal tax on dividends received from a foreign subsidiary for the tax paid by the subsidiary to a foreign country on the foreign income represented by the dividends. However, a majority of the voting stock of the foreign subsidiary must be owned by the domestic corporation claiming the credit.

The foreign tax credit, in addition to eliminating double taxation, assures the imposition of the same aggregate tax on all United States taxpayers regardless of where the income is derived.

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This is only effective, of course, where the rate of foreign tax is not higher than the United States rate. A taxpayer may, if he chooses, deduct all foreign taxes from his gross income without limitation. In some cases, it may be to his advantage to do so, because of the limitations on the foreign tax credit.

In spite of these provisions, the Internal Revenue Code does not entirely eliminate international double taxation on American citizens and corporations, because of differences in the interpretation of certain tax items and in definitions which exist between the United States and foreign countries.

An example of this is the famous Biddle case, which concerns credit given for taxes paid by an American investor to the British Government.[1] The American taxpayer, in the Biddle case, was a stockholder in a British corporation who felt that the British tax collected from the corporation was paid by him as a stockholder. Consequently, he asked for credit for the tax paid to the British Government, citing section 131 of the Internal Revenue Code. A conflict arose because, under the British law, this was a tax on the stockholder although it was paid through and by the corporation, but, under United States law, the tax was on the corporation. In other words, according to the British law the stockholder had paid his tax, but according to the United States law he had not. Although this conflict was reconciled later by a tax treaty between the two countries, it serves to show how the Internal Revenue Code failed to solve the problem of double taxation completely.

[1] *Biddle* v. *U.S.*, 302 U.S. 573.

Difficulties have also arisen over the interpretation of "source of income." A Canadian subsidiary was selling goods to its American parent company at cost; consequently the subsidiary did not show a profit. The Canadian Government decided to allocate profits to the subsidiary in proportion to the percentage of the total assets of the American parent company represented by those of the subsidiary company. The Canadian Government then levied an income tax on the profits allocated to the Canadian subsidiary.

The American parent company then claimed a credit for the Canadian taxes paid on the percentage of its total income allocated to Canada, citing section 131 of the Internal Revenue Code. Nevertheless, Federal tax authorities argued that the Internal Revenue Code allowed credit only for taxes paid on income derived from foreign sources, and that the source of this income was in the United States. Therefore, no credit was allowed for the Canadian tax and the Federal Government taxed the entire income of the American parent company.

These differences of interpretation extend to the terms "permanent establishment," "allocable expenses," and others used in the Internal Revenue Code and the Regulations. Double taxation results because the Internal Revenue Code can interpret certain terms for Federal tax purposes, but cannot for foreign countries.

Double taxation of income leaving the United States often occurs because many foreign governments do not allow credit for taxes paid in other countries. For instance, if a British citizen receives income from American investments, this income is subject to a 30 per cent

tax under our Internal Revenue Code. At the same time, the British Government will tax the entire income without giving credit for the 30 per cent tax paid to the United States Government.

In addition to the problems created by differences of definition and interpretation between the United States and other nations, there are administrative problems which the Internal Revenue Code fails to solve. When tax credits and exemptions are granted, tax evasion is sometimes a concomitant. To combat tax evasion, there is need for mutual administrative assistance between the United States and other countries for which the Internal Revenue Code, of course, does not provide. Mutual assistance in the assessment and collection of taxes can be effected only through the administrative provisions included in tax treaties.

History of the United States Tax Treaty Program

Tax treaties were in effect in Europe before the first World War. They were not numerous, however, until the termination of hostilities. Although the European nations went about tax treaty negotiations enthusiastically, the United States remained cold to the idea throughout the period immediately after the war. The Federal Government did attempt to mitigate the evils of double taxation by passing revenue acts designed to afford relief. However, tax treaties were not encouraged.

One reason for our reluctance to enter into tax treaties was the country's attitude toward isolation. This nation did not actively support the League of Nations, and many felt that binding agreements with any foreign nations might lead to conflict.

Another reason for America's attitude toward tax treaties during this period was the economic condition of the country. In the 'twenties, prosperity prevailed and people were apparently satisfied with the status quo. While international double taxation flourished, the interests of the country were focused on the lush profits and the interest in tax treaties was indeed small.

American prosperity came to a halt in the Fall of 1929. The economic crash of that year had wide effects, and many nations felt that they had a common enemy to fight.

Dr. Thomas S. Adams, Chairman of the Committee on Double Taxation, American Section, International Chamber of Commerce, had long been a proponent of international tax treaties, but he had to be content with originating the provisions for relief from double taxation in the Internal Revenue Code. Dr. Adams' ideas began to gain attention in 1930 because, at that time, America was willing to listen to ideas which promised to better the existing situation by eliminating barriers to the international flow of goods and by removing other conditions which seemed unfavorable to the nation's economy.

The United States finally heeded the advice of Dr. Adams, Secretary of the Treasury Mellon, Mr. Eldon P. King, now Special Deputy Commissioner of Internal Revenue, and others by accepting an offer from France to negotiate a treaty for the elimination of double taxation on corporate and individual income. Although negotiations on this treaty started in 1930, the treaty was not ratified for several years, becoming effective January 1, 1936. This treaty was superseded by another treaty with

France, signed July 25, 1939, but which did not become effective until January 1, 1945, because of delays associated with World War II.

At the present time this country has taken the initiative in a tax treaty program. This initiative probably stems from the fact that in 1946 Americans had $20.9 billion invested all over the world.[2] The many difficulties that individuals and companies have run into away from home have stimulated our interest in tax treaties. There have been many differences of opinion over the details of our tax treaties but not on their over-all objectives.

At present the United States has four income and two estate tax treaties in force. Several more treaties are in the process of negotiation, while some are before Congress for ratification.

United States Income Tax Treaties Now in Effect

The four income tax treaties now in force are with Sweden, France, Canada, and the United Kingdom.

Sweden

The treaty with Sweden, which went into effect on January 1, 1940, has three objectives: (1) the avoidance of double taxation; (2) the exchange of information; and (3) mutual cooperation in enforcement of the taxes to which the treaty relates.[3]

With respect to dividends, article VII provides that they shall be taxed only in the contracting country in which the shareholder has his residence, or if the shareholder is a corporation, in the country in which it is organized. Each country is permitted to deduct a tax of 10 per cent withheld at the source. Thereafter, the United States undertakes to continue, for a stipulated period, the existing rate of 10 per cent withheld at source on dividends from sources within the United States paid to residents or corporations of Sweden. Sweden will reduce the Swedish national income and property tax on dividends payable to American citizens and corporations from the existing rate of about 13 per cent to 10 per cent. The article contains a special clause by which it may be terminated by either country at the end of two years from the effective date of the treaty or at the end of any year thereafter on at least six months' notice.

In the event that this provision is terminated, certain other provisions favorable to the United States will likewise terminate. One of these, in article XIII (2), is a waiver by Sweden of its property tax on American holders of Swedish securities who are nonresidents of Sweden. This Swedish property tax amounts to 2 per cent in the case of individual holders and from 3 per cent to 5 per cent in the case of corporate holders. Since a large percentage of American trade with Sweden is carried on by Swedish subsidiaries of American companies, this article represents a material concession by Sweden.

The United States, according to articles II to XIV, inclusive, will avoid double taxation by employing our existing system of allowing credit for foreign taxes paid which, in so far as it concerns income derived from Swedish sources by United States citizens, resi-

[2] *Foreign Assets and Liabilities of the United States and Its Balance of International Transactions*, 80th Cong., 1st sess., Print of the Senate Committee on Finance, 1948, p. 51.

[3] The text of this treaty is given in Senate Executive Report No. 18, 76th Cong., 1st sess., *Sweden—Double Taxation*, dated July 20, 1939.

dents, and corporations, will be retained in force for the life of the treaty.

The revenue laws of Sweden do not contain any provision for credits for foreign income taxes paid. However, Sweden agrees to allow Swedish nationals and corporations a deduction for United States income taxes paid on income they derive from United States sources. This corresponds substantially to the credit allowed by the United States under its existing law. With respect to Swedish taxes imposed at a flat rate, Sweden will exclude from the income subject to such tax, the income derived from United States sources. Thus Sweden, in articles II to XIV, inclusive, in effect agrees to adopt our system of credit for foreign taxes paid in so far as it concerns the United States tax imposed upon income derived in the United States by Swedish residents and corporations.

Articles XV—XIX, inclusive, adopt the principles of exchange of information and mutual assistance in the service of documents and cooperation in the enforcement of the taxes with which the treaty is concerned. The United States revenue authorities will obtain from Sweden certain information relating to investment and other income derived from Swedish sources by United States residents and corporations. Supplementary information relating to certain financial activities of American citizens will also be given.

Similarly, the United States will furnish the Swedish authorities information with respect to income derived from United States sources by Swedish nationals. Under article XVIII, each contracting state undertakes to furnish to the other information in specific cases relating to taxpayers whose identity is known and whose property is situated in the other contracting state. Article XVII deals with mutual assistance in the collection of taxes to which the treaty relates.

France

The treaty with France, which went into effect on January 1, 1945, has four objectives: (1) avoidance of double taxation; (2) exchange of information; (3) mutual cooperation in the collection of the taxes to which the treaty relates; and (4) correction of certain defects in the treaty of 1932 and extension of the application of that treaty to taxes other than those covered by it.[4]

Article 10, by exempting, on a reciprocal basis, earned income derived by citizens of the United States or France, respectively, from the exercise of the "liberal professions" in the other country unless they have, in the other country, substantially the equivalent of an office or place of business, represents a liberalization of our existing law—sections 119(a)(3) and 211(b) of the Internal Revenue Code. However, the definition of the term "liberal profession" to which both governments will adhere excludes therefrom such individuals as actors and professional athletes.[5]

In conformity with the tax-treaty policy of both the United States and France, certain other provisions of the

[4] The text of this treaty is given in Senate Executive Report No. 4, 78th Cong., 2d sess., *France—Double Taxation*, dated December 5, 1944.

[5] The term "liberal professions," a literal translation of the French term *professions liberales*, refers principally to doctors, lawyers, and others who exercise their calling on their own account and not usually as employees of others.

previous treaty of 1932, relating to industrial royalties and personal emoluments, have been slightly broadened in the present treaty. Now exemption from tax at the source will depend on the test of residence as contrasted with the test of both residence and citizenship applied under the previous convention between these two nations. To grant a corresponding exemption to that extended by France to American shipping enterprises, article 13 exempts French shipping enterprises from the United States capital-stock taxes.

The effect of articles 2 to 14, inclusive, is that each country will avoid double taxation on certain items of income — real property, commercial profits, royalties, pensions, and capital gains. To accomplish this, the United States will employ its existing system of credit for foreign taxes paid, which will be retained in force for the life of the treaty. On the other hand, France will allow, against its so-called " schedular " taxes, a credit of 12 per cent of the income upon which United States taxes are paid on dividends, interest, and trust income from the United States sources. This credit is generally somewhat in excess of the United States tax on this income. Other income earned and taxable in the United States, such as business income, lease rentals, and mineral royalties, will be wholly exempted from the French " schedular " tax. Thus France, in effect, agrees to adopt our system of credit for United States taxes.

Articles 20 to 24, inclusive, constitute the adoption of the principles of exchange of information and mutual cooperation in the collection of the taxes with which the convention is concerned. These aspects of the treaty are similar to the corresponding articles of the treaty between the United States and Sweden.

Through the operation of article 8, employees of the Government of the United States, resident in France, will be relieved of the French " schedular " and general income tax reciprocally with the exemption, from the United States normal tax and surtax, of French Government employees in the United States. Similarly, on a reciprocal basis, retirement pay has been exempted by article 8, together with war pensions, previously exempted from taxation in the earlier treaty.

Article 19, relating to direct and personal taxes, both national and local, follows the principle of many consular treaties now in effect between the United States and foreign countries, including France. These treaties state that consular officers of one country resident in the other are exempted from national, state, and local personal income taxes in the latter country except for taxes on real property. In recent years, provisions have been embodied in our revenue laws, under which all foreign government employees generally are exempt, on a reciprocal basis, from the United States Federal income tax. Article 19 extends this principle, on a reciprocal basis, to state and local personal income taxes as well.

Article 18 is designed to lay the basis for a solution of a number of cases involving French citizens and French corporations deriving capital gains from the sale or exchange of securities upon American exchanges for years prior to 1936. In the Revenue Act of 1936, nonresident aliens were exempted from taxes on capital gains. Many cases of

capital gains prior to this year were in dispute. The disposition of such cases is almost always attended with considerable difficulty and is productive of irritation with foreign countries, which generally do not impose income tax on capital gains.

The provisions of this treaty, other than those dealing with the solution of problems peculiar to France, parallel closely those of the treaty between the United States and Sweden.

Canada

The major provisions of the treaty with Canada, which went into effect retroactively to January 1, 1941, may be summarized as follows: (1) the adoption of principles for the determination and taxation of business income derived by enterprises of one of the contracting states from sources within the other contracting state; (2) the reciprocal exemption from taxation of certain items of income derived from sources within one country by residents or corporations of the other country; (3) the reduction, reciprocally, to 15 per cent in the rate of taxation upon certain income derived by individual residents of Canada and by Canadian corporations from United States sources —if such persons and corporations are not engaged in trade or business within the United States and have no office or place of business therein; (4) the alleviation, with respect to Canada, of certain allegedly extraterritorial taxation by the United States of nonresident aliens and foreign corporations; (5) the settlement of certain pending cases of Canadian residents and Canadian corporations involving the taxation of capital gains; and (6) cooperation between the two countries directed against tax evasion.[6]

The treaty is similar to those between the United States and France and between the United States and Sweden.

The 30 per cent rate of United States income tax, generally applicable to nonresident alien individuals and nonresident foreign corporations, is reduced by article XI to 15 per cent in the case of residents of Canada and Canadian corporations. In the case of dividends paid by a United States domestic subsidiary corporation to its Canadian parent corporation, the rate is reduced to 5 per cent. The corresponding income taxes collectible by Canada from residents and corporations of the United States are limited to the same rates.

Article XII exempts dividends and interest paid by Canadian corporations to Canadian residents, other than American citizens, or to Canadian corporations from United States income taxes. Canadian corporations with more than 50 per cent of the outstanding voting stock owned throughout the last half of the taxable year by residents of Canada, other than American citizens, are exempted by article XIII from United States taxes on accumulated or undistributed earnings, profits, income, or surplus.

Article XIV attempts to solve the problem of the taxation of nonresident aliens and foreign corporations upon capital gains derived from transactions upon American security and commodity exchanges. This article confers discretion to deal with these cases individually upon the Commissioner of Internal Revenue.

[6] The text of this treaty is given in Senate Document, Executive B, 77th Cong., 2d sess., *Taxation Convention with Canada,* dated March 9, 1942.

An important step in the direction of fiscal cooperation between the two countries in the field of income taxation is taken in articles XIX, XX, and XI. By means of these articles the United States will obtain, upon a reciprocal basis, information on a comprehensive scale with respect to income derived by residents of the United States from Canadian sources and information concerning specific taxpayers where available in Canada. These principles materially complement our domestic system of information at the source and should be of value in the administration of the revenue laws.

Great Britain and Northern Ireland (United Kingdom)

The principal features of the income tax treaty with the United Kingdom are summarized in the following paragraphs.[7]

By article I, the treaty is made applicable, in the United States, only to Federal income taxes, including surtaxes and excess-profits taxes. Consequently, the treaty does not apply to taxes imposed by the several states of the United States, with one exception, namely, article XXI.

The 30 per cent rate of United States tax, generally applied with respect to nonresident aliens and nonresident foreign corporations, and the higher rates of normal tax and surtax, also applied to such aliens, are reduced, by article VI, to 15 per cent in the case of dividends paid by a United States domestic corporation to residents of the United Kingdom and United Kingdom corporations. A like reduction to 15 per cent is applied, under article IX, to gross mineral royalties and to gross real property rentals derived from United States sources by residents of the United Kingdom. The United Kingdom does not impose normal tax on dividends as such, but does impose surtaxes on dividends. Under the proposed treaty, dividends moving to the United States from the United Kingdom will be exempt from United Kingdom standard tax and surtax.

By article VII and VIII, interest and industrial royalties are wholly exempt from taxes upon a reciprocal basis. Accordingly, interest and royalties will move to the United States from the United Kingdom free from the United Kingdom tax of 50 per cent and from the United States to the United Kingdom free from the United States tax of 30 per cent.

The United States agrees to continue, under article XI, during the lifetime of the treaty, its existing system of credit for foreign taxes in so far as credit for the United Kingdom income tax is concerned, and to liberalize the system so as to allow credit for United Kingdom taxes on earnings out of which dividends are paid to United States shareholders of United States corporations. The United Kingdom, on the other hand, agrees to adopt the system of credit for United States taxes imposed upon income derived from United States sources by residents of the United Kingdom or by United Kingdom corporations.

It has long been a provision of United States revenue laws that dividends paid

[7] The text of this treaty is given in Senate Executive Report No. 4, 79th Cong., 2d sess., *Convention With Great Britain and Northern Ireland With Respect to Taxes on Income*, dated May 10, 1946. This treaty was modified somewhat by a protocol. See Senate Document, Executive F, 79th Cong., 2d sess., *Supplementary Proctocol Relating to Taxes on Income*, dated June 11, 1946.

by a foreign corporation, located in the United States, to nonresident aliens or foreign corporations are to be regarded as income from sources within the United States. These dividends are taxable by the United States even though the recipient of such dividends and the foreign corporation paying them are not resident in the United States. The United Kingdom law does not contain any corresponding provision. This provision of the United States revenue laws has been the object of frequent objections on the grounds of extraterritorial taxation. The existing income tax treaty with Canada makes that provision inapplicable to residents of Canada. Article XV of the treaty with the United Kingdom makes the provision inapplicable to residents of the United Kingdom.

Similarly, article XVI makes the personal holding company provisions of the United States revenue laws inapplicable to United Kingdom corporations controlled by residents of the United Kingdom. In this respect, article XVI is identical in principle with article XIII of the income tax treaty between the United States and Canada, which makes the personal holding company provisions inapplicable to Canadian corporations. Article XVI of the convention with the United Kingdom contains safeguards against the use of the exemption as a means of tax avoidance.

Article XVII is identical in principle with article XIV of the income tax treaty with Canada. Under article XIV of that treaty, the settlement of cases involving Canadians and Canadian corporations prior to 1936, and involving the taxation of capital gains from sources within the United States, has been facilitated. While the number of similar cases involving United Kingdom residents and United Kingdom corporations is believed to be small, it was felt desirable to extend to the United Kingdom the same provisions in this respect as are found in the existing treaty with Canada.

An important step in the direction of fiscal cooperation between the United States and the United Kingdom in the field of income taxation is marked by Article XX. Under this article the United States will obtain, upon a reciprocal basis, information on income derived by residents of the United States from sources in the United Kingdom, as well as information concerning specific taxpayers where information is available to the revenue authorities of the United Kingdom. These provisions complement the United States domestic system of information at the source.

An innovation is found in article XXII where the basis is laid for the application of the treaty to colonies, overseas territories, and certain other areas over which authority is exercised by the respective governments. It is anticipated that many of the British colonies or other territories, which have tax systems closely analogous to that existing in the United Kingdom, will elect in the course of time to come within the scope of the treaty. This should provide a solution to problems of income taxation which may exist between the United States and these colonies. Inasmuch as the United States revenue laws do not extend to overseas possessions, such as Puerto Rico, those possessions will be free to elect to come within the scope of the treaty as they see fit.

United States Estate and Inheritance Tax Treaties Now in Force

The reasons for launching an income tax treaty program apply to death tax treaties also. Conflicts over such terms as " situs " and " domicile " can be reconciled only through tax treaties. At the present, the United States has two death tax treaties in force, although others are in the process of negotiation or ratification.

Canada

The treaty with Canada is intended to reduce double taxation arising from the application, to the same estate or succession, of both Federal estate taxes and Dominion succession duties and to provide for mutual administrative assistance to restrain tax evasion.[8]

The treaty extends only to estate taxes imposed by the Federal Government and succession duties imposed by the Dominion Government. The imposition and collection of taxes by political subdivisions—that is, by states or provinces—are, therefore, not affected by the treaty.

Federal estate taxes are imposed upon the entire net estate on the occasion of its transfer rather than upon any particular share or part of it. The liability is not governed or conditioned by the relationship which may exist between the beneficiary and the decedent. Canadian succession duties are imposed upon the succession, or the right of the beneficiary to receive the property from the decedent, and both the rate of taxation and the exemptions allowable vary according to the relationship of the beneficiary to the decedent.

The fundamental provisions of the treaty are contained in articles V and VI. Article V provides for uniformity in two important particulars when the tax is imposed upon the basis of situs of property. Canada agrees to conform to the practice of the United States in determining the tax rate without taking into account the value of property outside the territory of the taxing government. The United States agrees to conform to the practice of Canada in allowing a proportionate exemption consisting of " an amount which bears the same ratio to the personal exemption allowed in the case of a decedent who was at the time of his death domiciled in Canada as the value of the property of such decedent situated in Canada bears to the entire value of the property, wherever situated."

Under the provisions of article VI, the United States and Canada, while continuing to impose estate taxes or succession duties in regard to the same property, will apply the principle of a reciprocal credit. In cases where the same property has been subjected to taxation by both countries, the country of domicile or citizenship in the case of the United States, or the country of domicile in the case of Canada, would accord relief against double taxation by allowing a credit for the tax paid to the other country. This plan is consistent with the reciprocal credit provisions in the existing income tax treaty between the two countries.

In the application of article VI, the credit allowable will be limited to those cases where double taxation otherwise would actually result. In the determination of the situs of property, ar-

[8] The text of this treaty is given in Senate Executive Report No. 3, 78th Cong., 2d sess., *Canada—Double Taxation,* dated December 5, 1944.

ticle VI adopts and applies the rule set forth in article IV, except as qualified in article III, that the situs of property shall be determined in accordance with the laws of the contracting state imposing the tax.

Article II confirms the existing laws and practices of the two countries with respect to the taxation of real property situated outside the territory of the taxing authority. Real property situated in the United States is exempted from Canadian succession duties, while real property situated in Canada is exempted from Federal estate taxes. If in any case a right, relating to or secured by real property, were to be taxed by both governments, it is contemplated that the reciprocal credit provisions would afford relief against double taxation.

Article III contains the only specific determination of situs other than for real property. It provides that shares in a United States corporation shall be regarded as property situated within the United States and shares in a Canadian corporation shall be regarded as property situated in Canada. Since the existing laws are divergent, a uniform rule in relation to the situs of shares of stock of United States and Canadian corporations appeared to be particularly desirable. A basis for a uniform rule existed in the adoption, upon a reciprocal basis, of that principle of the Federal estate tax laws whereby corporate stock is considered as having its situs in the country in which the corporation issuing the stock is created or organized.

Under article IV the situs of property is to be determined, except as provided in article III, in accordance with the laws of the taxing government, as are allowances for debts and questions with respect to domicile.

Articles VII to XI, inclusive, contain provisions relating to administrative cooperation to prevent tax evasion and to reduce administrative delays in connection with the settlement of estates.

Great Britain and Northern Ireland (United Kingdom)

The estate tax convention with the United Kingdom, like that with Canada, proposes to eliminate double taxation which otherwise would result from the application to the same estate of both Federal estate taxes and British estate duties.[9] It contains provisions relating to mutual administrative assistance through the exchange of information with a view to discouraging tax evasion.

As in the case of the treaty with Canada, it applies, in so far as the United States is concerned, only to estate taxes imposed by the Federal Government. The imposition and collection of inheritance or estate taxes by states, territories, or the District of Columbia are not restricted by the treaty. As to the United Kingdom, the treaty is applicable to the estate duty but does not apply to United Kingdom legacy or succession duties.[10]

In the imposition of the United States estate tax, estates of decedents are classified in two categories: first, estates taxed on the basis of domicile or citizen-

9 The text of this treaty is given in Senate Executive Report No. 5, 79th Cong., 2d sess., *Convention with Great Britain and Northern Ireland with Respect to Taxes on Estates of Deceased Persons,* dated May 10, 1946.

10 The United Kingdom estate tax is a tax on the entire amount of property, while the legacy or inheritance tax is a tax on the portions of the estate going to the heirs.

ship (decedents who were domiciled in, or citizens of, the United States); and, second, estates taxed on the basis of the situs of property (property situated in the United States in cases of noncitizens of the United States domiciled outside the United States).

Under the Internal Revenue Code, the Federal estate tax applies to the entire estate of a *citizen* of the United States regardless of where domiciled or where the property is situated, with the one exception that it does not apply to real estate located outside of the United States. The convention does not change these rules, but removes double taxation by allowing a credit under article V(1) for the British or Northern Irish estate duty paid with respect to property—other than real estate — situated in Great Britain or Northern Ireland.

The convention allows a further credit under article V(2) in any case where the United States imposes a tax by reason of the decedent's domicile in this country in accordance with the laws of the United States, and the United Kingdom imposes a tax by reason of the decedent's domicile in that country in accordance with the laws of the United Kingdom. It is not anticipated that such cases of "double domicile" will be of frequent occurrence.

As in the case of the estate of a citizen of the United States, the Federal estate tax applies to the entire estate—other than real estate outside the United States—of a *noncitizen* who, at time of death, was *domiciled in the United States*. The convention removes double taxation by allowing a credit for the British or Northern Irish estate duty paid on property situated in Great Britain or Northern Ireland.

The convention also provides for a further credit in the case where the United States imposes a tax by reason of the decedent's domicile in this country in accordance with the laws of the United States, and the United Kingdom imposes a tax by reason of the decedent's domicile in that country in accordance with the laws of the United Kingdom.

The Federal estate tax is applicable only to property situated within the United States, in the case of an *alien domiciled in the United Kingdom* at time of death. Under the United States law, stock in a foreign corporation is deemed to be property situated within the United States if the stock certificate is physically located in the United States. Moreover, stock in an American corporation is held to be property situated in the United States regardless of where the certificate is located. Under article III of the convention—in the case of the estate of a decedent who at time of death was domiciled in either of the contracting countries—stock in any corporation is deemed to be situated in the country in which the corporation was created regardless of the location of the stock certificate. The convention adopts the second American rule of situs with respect to stocks.

Under the United States law, bonds, regardless of the residence of the obligor, are held to be situated in the country where the bond certificates are located. Under article III of the convention, debts, including bonds, are regarded as located in the country where the decedent was domiciled at the time of death. This rule in effect

constitutes an exemption from the tax imposed upon the basis of situs of property.

Other rules of situs set forth in the convention confirm the existing rules relative to the estate tax under the Internal Revenue Code, including the situs of real property, intangible personal property, ships, patents, trademarks, copyrights, good will, and judgment debts. Proceeds of a life insurance policy and bank accounts are, under the treaty, regarded as located in the contracting country where the decedent was domiciled at the time of death and constitute in effect exemptions from taxes imposed on the basis of situs of property. Under the Internal Revenue Code insurance proceeds and bank deposits are similarly deemed situated outside the United States and in effect exempted from the tax imposed upon the basis of the situs of property.

The convention makes no change in the Federal estate tax law as applied to the estate of a *nonresident alien not domiciled in the United Kingdom* or any of its colonies or territories to which the convention may be extended. The existing Federal estate tax law provides that the estate of such an alien is taxable on his property situated within the United States. For example, if the certificate of stock in a foreign corporation, including stock in a British corporation, is physically located in the United States, the stock is still regarded as property situated within the United States.

Estates of decedents are classified in two categories in the imposition of the estate duty in Great Britain or Northern Ireland: first, estates taxed on the basis of domicile—decedents who were domiciled in Great Britain or Northern Ireland—and, second, estates taxed on the basis of the situs of property—property situated in Great Britain or Northern Ireland in the cases of decedents who at time of death were domiciled outside Great Britain or Northern Ireland. Unlike the United States law, no distinction is made as to citizenship.

In the case of a *decedent,* whether or not a United States citizen, *domiciled in Great Britain* or Northern Ireland at the time of his death, the estate duty applies to all of his property wherever situated except immovable property outside Great Britain or Northern Ireland. This rule is not changed by the convention. However, double taxation is avoided under the convention on property situated in the United States by allowing a credit under article V(1) for the United States tax paid on this property. The convention also provides for a further credit under article V(2) in the case where the United Kingdom imposes a tax by reason of the decedent's domicile in that country in accordance with the laws of the United Kingdom, and the United States imposes a tax by reason of the decedent's domicile in this country in accordance with the laws of the United States. No corresponding provision exists in the Canadian convention.

If a *decedent* is *not domiciled in Great Britain* or Northern Ireland at the time of his death, the estate duty applies only to property situated in Great Britain or Northern Ireland. In the case of a *decedent domiciled in the United States,* stock in any corporation is, under article III of the convention, held to be located where the corporation

was created regardless of the location of the stock certificates or the transfer agent.

The convention contains provisions—article VII—for the exchange of information between the United Kingdom and the United States with respect to death taxes similar to those included in the death duty convention between the United States and Canada.

Treaties in Process of Negotiation and Ratification

In addition to the treaties now in force, several more are in the process of negotiation or ratification. Negotiations have been held with South Africa, Belgium, Luxembourg, the Netherlands, Denmark, the Philippines, New Zealand, and Mexico. A proposed treaty and a protocol with France, dealing primarily with estate taxes but containing some amendments to the existing income tax treaty, have also been negotiated. The treaties with the Netherlands and Denmark have been ratified with reservations. The Senate did not approve those articles exempting foreigners from our capital gains tax. Both the treaty and the protocol with France have now been ratified. If and when Denmark and the Netherlands accept these reservations, and when France has ratified the protocol, the treaties will go into effect.

Preliminary discussions have been held with other countries which may ripen later into public announcement of formal negotiations. Our backlog of negotiated tax treaties is beginning to exceed our production of ratified treaties.

Until the submission of the treaty with France to the Senate for ratification, but little opposition to the tax treaty program was manifest. The proposals for administrative assistance embodied in this treaty aroused the opposition of the National Foreign Trade Council, the Committee on Taxation of the United States Associates of the International Chamber of Commerce, certain American business interests, and some American citizens resident in France.

The opponents of this treaty agreed neither with the provisions for the restriction of tax evasion which included the exchange of fiscal information concerning taxpayers in both countries, nor with the collection of taxes, without regard to the principle of nationality, by the United States on behalf of France. Objections to certain other provisions were also voiced.[11]

[11]Senate Executive Report No. 7, 80th Cong., 2d sess., *Convention and Protocol Between the United States and France on Double Taxation,* dated May 26, 1948, summarized, on page 2, these objections as follows:

"1. Through article 12 of the convention the United States would, upon request by France, take measures looking to collection of French tax from taxpayers in the United States, including United States citizens and domestic corporations.

"2. Through article 9 (1) information automatically transmitted to France, with respect to investment income derived from United States sources, would include such information with respect to United States citizens having an address in France.

"3. Information to be transmitted by the United States to France upon request by that country would include information in the case of United States citizens and domestic corporations.

"4. Status of United States citizens residing in France with respect to their domicile in that country for French inheritance tax purposes is not protected from possible changes in the French law and practice with respect to what constitutes domicile in France for such purposes.

"5. The convention does not prevent the application of the French national solidarity tax to United States citizens and corporations and contains no provisions to protect against future French capital taxes.

"6. The severity of the French income-tax burden in its application to United States citizens residing

On May 17, 1948, a protocol was signed with France eliminating those features which aroused the greatest opposition.

Principles Involved in the United States Tax Treaties

In analyzing the principles of the United States tax agreements designed to eliminate double taxation and prevent tax evasion, we are confronted with two principles which frequently come into conflict. One principle emphasizes *tax exemption at the source,* location, or origin of income and property in order that the entire tax may be collected in the residence country. The other proposes *tax collection at the source,* origin, or location, with the residence country giving tax credit for the taxes paid in the source country. Most European nations favor the former principle while the United States leans toward the latter.

The credit principle is often used in conjunction with the source and origin tax principle because the tax is levied at the source or origin of the income while credit for these taxes is allowed at the residence. The exemption principle often accompanies the domicile and residence tax principles because the tax is exempted at the source or origin of the income and levied at the residence.

Since the United States utilizes the credit principle in its Internal Revenue Code, it has naturally turned to this method in tax treaty negotiations. It was found, however, that most foreign governments preferred the more direct system of eliminating double taxation through exemption from taxation at the source. A compromise, therefore, between the two methods has been embodied in all tax treaties to which the United States is a party.

Business Income.—With respect to business income, all of the tax treaties of the United States contain the provision that one country will refrain from taxing the industrial and commercial profits of a business enterprise of the other country except in respect to profits attributable to the permanent establishment situated within the former country. Unless such a permanent establishment exists, the enterprise of one country may sell its goods in the other country without being subject to tax. However, if a permanent establishment does exist, measures are provided for ascertaining the profits attributable to the branch.

Under this system the definition of the term " permanent establishment " is necessarily of considerable importance. All treaties include in their definition of this term a branch, management, factory, or other fixed place of business and exclude bona fide commission agents or brokers acting in the ordinary course of business.

Adoption of the principle that the country where the permanent establishment is situated will tax only the income attributable to the permanent establishment necessarily brings into play the problem of allocating income to

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in France and employed by American business therein is not alleviated by the convention.

"7. In the case of United States citizens domiciled in France for income-tax purposes no definite assurance is given that such citizens are not subject to the French general income tax upon income derived by them from sources outside France.

"8. The allowance of credit by France for United States tax on income from United States sources of 25 points against the French schedular tax on the same income derived by residents of France is not sufficient to avoid double taxation."

the permanent establishment, especially with regard to income attributable to activities carried on in the two countries. Although all our treaties have envisaged the adoption, in principle, of the basis of separate accounts as between the enterprise and its permanent establishment abroad, there are variations in the methods employed in our several treaties.

The treaties with Sweden and France provide that the competent authorities of the countries may lay down rules by agreement for the apportionment of industrial and commercial profits.

After specifying certain rules with respect to the allocation of industrial and commercial profits, our treaty with Canada concludes with a grant of general authority to the countries to consult together with a view to the adoption of uniform rules of allocation of profits. The more detailed approach used in the Canadian treaty follows that of the model treaties compiled at Geneva by the Fiscal Committee of the League of Nations.

Our treaty with the United Kingdom adopts a middle course by prescribing rules of allocation in less detail than those found in the treaty with Canada and omits the express provision authorizing the competent authorities to confer for the purpose of prescribing rules of allocation.

Where an enterprise of one country realizes industrial and commercial profits in another without having a permanent establishment there, double taxation is eliminated by reserving the right of taxation exclusively to the former country. Where a permanent establishment does exist, the plan of our existing treaties has been to eliminate double taxation by the following methods: The country in which the enterprise was organized or created either exempts the income of the permanent establishment from taxation or permits the tax of the other country, in which the permanent establishment is located, to be deducted from the tax of the enterprise on such income.

Investment Income.—Of the items of investment income, the treatment of dividends is by far the most important since they have been estimated to represent about 85 per cent of the total international flow of income.[12]

At the time when our treaty with Sweden was negotiated, our tax rate on dividends passing to nonresident aliens and foreign corporations was 10 per cent while the Swedish rates on individual income flowing from that country to nonresident aliens and foreign corporations were substantially higher. An arrangement was worked out whereby the Swedish rates were reduced and the United States agreed to adhere to its existing rate of 10 per cent. Supplementing the establishment of these rates, the United States agreed to adhere to its statutory system of granting credit for the Swedish tax against the United States tax, and Sweden established a credit of 10 per cent of the income on which United States taxes were paid.

In the case of Canada, the United States reduced its rate on dividends from 30 per cent to 15 per cent, except in the case of intercompany dividends meeting certain specifications, where the rate was reduced to 5 per

[12] Eldon P. King, "Tax Treaties and International Double Taxation," speech before the Tax Executives Institute, Inc., September 16, 1947, Atlantic City, New Jersey (mimeographed).

cent. These reductions corresponded to the Canadian rates of 15 per cent and zero, respectively. Further relief was given through the operation of the credit provisions contained in the laws of the respective countries. Thus, under section 131 of the Internal Revenue Code, the United States grants relief with respect to the Canadian 15 per cent rate and, under section 8 of the Canadian Income War Tax Act, Canada grants relief from the United States tax burden.

In the United States treaty with France, the statutory rates on dividends were left undisturbed and the countries agreed to adjust double taxation through the credit method. However, as in the case of Sweden, it was necessary for France, in the absence of existing statutory provisions, to adopt a credit system as part of the tax treaty.

In adjusting the taxation of dividends with the United Kingdom, the United States rate was again reduced to 15 per cent generally and to 5 per cent in the case of certain intercompany dividends and, as in the case of France, the United Kingdom found it necessary to set up a credit system by treaty in the absence of existing statutory provisions. As a part of the convention, the United States agreed that the American minority shareholder in United Kingdom corporations would be deemed to have paid the British tax and would therefore be entitled to a credit for the British tax against the United States tax on such dividends. Prior to the treaty (under the authority of *Biddle, et al.* v. *Commissioner*, 302 U.S. 573), such a United States shareholder had been denied the credit for the British tax.

The elimination, or alleviation, of double taxation with respect to interest payments passing from debtors in one country to creditors in another has varied considerably in the United States tax treaties. For example, in the treaty with the United Kingdom, double taxation was eliminated by reserving the right to tax solely to the country of residence, except for United States citizens. In the treaty with France, each country reserved the right to tax, supplemented by an adjustment through the credit principle. The approach to the problem employed by Canada involves the combined reduced rate and credit method, while Sweden exempted interest at the source, and the United States taxed it. For certain internal reasons Sweden was not able to grant a credit for United States taxes paid against the Swedish tax.

Industrial royalties rank next to interest in importance, and the plan followed in our treaties with the United Kingdom, France, and Sweden with respect to the taxation of industrial royalties from patents and copyrights is to reserve the right of taxation exclusively for the country of residence rather than source, again excepting American citizens liable to United States taxation. The method employed with Canada was again a combination of reduced rate and credit corresponding to that applied to dividends.

Pensions and life annuities have been uniformly exempted from tax at the source and taxed at the residence of the recipient of such items of income.

Miscellaneous Adjustments.—Of the various miscellaneous adjustments made by treaty, those pertaining to shipping and aircraft operations and temporary business visitors are of greatest interest. All countries with which we have concluded treaties have adopted the principle of reserving taxation to the country where the ships or aircraft are

owned and registered. This has eliminated many problems incident to the allocation of income to the country visited by the ship and has tended to encourage shipping and aircraft activities between countries which have adopted such provisions.

In our treaties with Sweden and Canada, provision is made whereby the residents of one country can perform personal services within the other for a brief period without incurring tax liability, but the public entertainer is excluded from these benefits. However, upon further review of this principle in our treaty with the United Kingdom, the Foreign Relations Committee of the United States Senate objected to this exclusion, and a subsequent protocol amendment to the treaty extended the exemption, in this treaty, to the public entertainer.

Estate Taxes.—In the imposition of the estate tax in the United States, estates of decedents are classified for taxation in two categories: first, estates taxed on the basis of domicile or citizenship (decedents who were domiciled in, or citizens of, the United States); and, second, estates taxed on the basis of situs of property (property situated in the United States but whose owners live elsewhere).

In concluding the estate tax treaties, the second category was the principal one considered. In both of the estate tax treaties, the negotiating authorities came to agreement concerning the establishment of situs rules and agreed that any other situs points which arose would be determined under the laws of the respective countries. After determining situs, the country of domicile of the decedent then gives a credit against the tax of the country of situs.

Administrative Cooperation.—In our treaties, provision has been made for the exchange of information automatically in certain instances and, in others, for one country to give information in particular cases on request of the other country. In some degree provision has also been made in all our income tax treaties for cooperation in tax collection. Automatic exchange of information comes into play especially where the countries have waived taxation at the source in favor of taxation at residence. Cooperation in collection is also of special importance in connection with items which flow from the country of source, either tax-free or at reduced rates, to recipients in the other country.

In cooperation in tax collection, there is substantial variation in the terms of our existing and pending treaties. Thus our treaties with Sweden and France contain broad authorizations, except that one country does not agree to collect the other's tax with respect to its own citizens or corporations. Our treaties with Canada and the United Kingdom contain no such authorization for collection.

In general, and as a part of the plan of eliminating or alleviating double taxation, the administrative provisions are intended to place those safeguards around the international system which countries generally insist upon with respect to their domestic systems.[13]

The principles of our tax treaty program are now well-established and are being employed, with appropriate minor modifications, in the treaties now in the process of negotiation. In all probability, we can look forward to an expanding program of tax treaties, with the encouragement to international traffic and investment which they afford, in the years ahead.

[13] Eldon P. King, *op. cit.*

FISCAL POLICY, MILITARY PREPAREDNESS, AND POSTWAR INFLATION

HASKELL P. WALD *

TOWARD the end of World War II there appeared a rash of articles on the general theme of alternative budget policies for achieving full employment in the postwar period.[1] The objective of these studies was to analyze the implications of different methods of varying government expenditures and revenues in order to secure an addition to total public and private outlay sufficient to absorb any manpower resources that otherwise would have remained idle.

It is interesting to translate these studies into the postwar inflationary setting. The requirements of national defense, international reconstruction, and related governmental programs placed Federal spending on a rising curve at a time when manpower and important raw materials and manufactured goods were in relatively tight supply. In such a situation the need was for a tax policy which would be consistent with general price stability and minimize the necessity for economic controls which are distasteful to the private economy. To the extent that the additions to government spending were not being fully offset by reductions in the private sector, the result was an intensification of inflationary pressures.

One's first reaction is to state that the answers to the fiscal-policy problem in such a setting are the opposite of those obtained under less-than-full-employment assumptions. Whereas loan-financed expenditures have the largest "leverage" factor, if the possibility of an unfavorable reaction on private investors is ruled out, such expenditures would be least appropriate when there is no slack in the economy; and tax-financed expenditures, particularly those financed by taxes which are most effective in restraining private investment and consumption spending, would be most appropriate.

These generalizations are valid, but they go too far in simplifying what is

* The author is an economist on the staff of the National Security Resources Board. This article expresses his personal views.

[1] For example, see: R. A. Musgrave, "Alternative Budget Policies for Full Employment," *American Economic Review,* XXXV (June, 1945), 387-400, and "Fiscal Policy, Stability, and Full Employment" in *Public Finance and Full Employment,* Board of Governors of the Federal Reserve System (Washington, 1945); N. Kaldor, "The Quantitative Aspects of the Full Employment Problem in Britain," Appendix C in *Full Employment in a Free Society* by W. H. Beveridge (New York, 1945); M. Kalecki, "Three Ways to Full Employment," Part III in *The Economics of Full Employment,* Oxford University Institute of Statistics (Oxford, 1944); A. H. Hansen, "Three Methods of Expansion Through Fiscal Policy," *American Economic Review,* XXXV (June, 1945), 382-387. Among the more recent analyses of the subject are: T. Morgan, *Income and Employment* (New York, 1947), pp. 218-223; P. A. Samuelson, "The Simple Mathematics of Income Determination" and R. I. Bishop, "Alternative Expansionist Fiscal Policies," in *Income, Employment, and Public Policy,* Essays in Honor of Alvin H. Hansen (New York, 1948). For a useful, simplified statement see, P. A. Samuelson, *Economics* (New York, 1948), appendix to chap. 18. An early treatment of the problem is H. M. Somers, "The Impact of Fiscal Policy on National Income," *Canadian Journal of Economics and Political Science,* VIII (August, 1942), 364-385.

basically a difficult problem in reconciling competing demands for limited resources. In the first place, a tax-financed expenditure program ordinarily will still have an income-generating effect, and thus will intensify demand pressures; as a general rule, both a careful selection of tax measures and a sizable budget surplus are necessary if the tax-induced cut in private spending is to offset the income-increasing effect of added government spending. Secondly, a variety of considerations may militate against relying solely on tax policies to curb the inflationary impact of increased spending for defense and related activities.

The purpose of this article is to illustrate certain fundamental principles of fiscal policy determination in an inflationary setting in which military preparedness is a prime objective of national policy. In the attempt to simplify the presentation and extend the analysis beyond the realm of theoretical reasoning, certain hypotheses are relied upon which must be subjected to further testing before they can be used as a basis for policy determination. Nevertheless, it is obvious that progress in clarifying broad policy principles is an important first step in the direction of formulating sounder tax policies. Moreover, the difficulties of deriving estimates of the economic effects discussed below should not be exaggerated; crude statistical approximations often can serve as useful policy guides.

REQUIREMENTS FOR NONINFLATIONARY FINANCING

It is easy to lose sight of the fact that the expansionary effects of an increase in government purchases of goods and services are not neutralized merely by a dollar-for-dollar increase in tax revenues, even though the individuals who pay the incremental taxes have consumption and savings habits which are identical with those of the recipients of incremental government expenditures.[2] Since the effect of the revenue-expenditure process is to transfer purchasing power from taxpayers to recipients of government expenditures, it is true that aggregate private demand remains unchanged as long as the consumption demand of the payers and payees is the same. In the meantime, however, government purchases will have increased, with a consequent rise in national production or, if the economy had already been operating at maximum rates, with a consequent rise in prices and some redistribution of output.[3]

Under the simplified assumption of a revenue-expenditure process which is neutral in its distributional aspects, therefore, the multiplier (which relates the tax-financed increase in government expenditures, as the multiplicand, to the increase in total outlay) is exactly one when there is a balanced increase in expenditures and taxes. If a full employment situation already prevails, the addition to government expenditures becomes, on balance, a dollar-for-dollar

[2] This point is ably developed by Henry C. Wallich in "Income-Generating Effects of a Balanced Budget," *Quarterly Journal of Economics*, LIX (November, 1944), 78-91. Samuelson refers to this proposition as the "balanced-budget theorem" and presents several explanations (see "The Simple Mathematics of Income Determination," *op. cit.*, pp. 140-142). The effects of time lags in the income-expenditure process are ignored in the present presentation. For most problems this is not a serious oversimplification, although it would still be important to allow for such lags when making policy decisions.

[3] Throughout this article the references to government expenditures apply only to purchases of goods and services, i.e., transfer payments are excluded.

addition to the inflationary pressure in the economy, even though the budget balance is undisturbed. Without recognizing this relationship, we miss the chief reason why the fiscal policy aspects of military preparedness in the postwar economy are not as simple as they first seem.

There is nothing mysterious about the income-creating effect of a balanced budget. Government spending for goods and services adds directly to the value of the gross national product; it enters the national product on the "first round," so to speak. Tax collections, on the other hand, do not enter until the "second round."[4] Taxes are paid in part from funds that otherwise would have been saved, so that the amount subtracted from gross national product falls short of the amount of additional revenue. Private disposable income, consumption, and savings are unchanged, however, since it is assumed that the effects of taxing and spending are of an offsetting character. What is added that is new is the expansion of the government sector.

The analysis might be extended a step further by taking into account the impact of the new expenditure and tax programs upon the level of private investment. Let us suppose that the added government spending stimulates an expansion in private investment and that the tax deterrent effects on investment incentives are of no consequence. The additional investment would then have a magnified effect on aggregate private outlay, and on what might be thought of as the "inflationary gap," because of the respending of the resultant increase in consumers' income. Conversely, a negative effect on investment would ease the inflationary pressure by more than a dollar-for-dollar reduction.

Given the decision to finance an increase in the government's budget in a manner which would not add to total public and private demand and thereby aggravate a pre-existing inflationary situation, either private investment or consumption, or both, must be curtailed in an amount equivalent to the added government expenditure.[5] There are analytical advantages in formulating the requirements for a noninflationary fiscal policy in algebraic terms in order to determine the general nature of the taxes that would need to be levied or the magnitude of the budget surplus that would be called for. This is done in the appendix accompanying this article. The implications of the algebraic analysis for policy formulation are illustrated in the following examples.

Example 1.—No Increase in Taxes

Under what is generally considered to be the most inflationary budgetary policy, the stepping up of government spending for goods and services would not be accompanied by any increase in tax rates. The additional spending would be financed through loans or

[4] It may be noted that government transfer payments, such as social security benefits, also enter on the "second round." Thus, raising taxes and transfer payments simultaneously will not have any multiplier effects (apart from the effects of redistribution among income classes).

[5] This is a minimum acceptable objective for a noninflationary fiscal policy. If fiscal policy is to make a positive contribution to an anti-inflation program, it should curtail private spending by more than the addition to government programs. Moreover, because the above statement is in terms of aggregates, there is an implicit assumption that resources will flow freely from one activity to another. Thus, it overlooks the risk of intensifying inflationary pressures in particular sectors of the economy, which is, of course, a real risk under postwar conditions.

through a reduction in a pre-existing budget surplus.[6] In such a situation the addition to aggregate public and private outlay would be (1) the original increment of government spending, plus or minus (2) the change in private investment spending, plus (3) the sum of the familiar chain of respendings of successive portions of the resultant increases in consumer income.

In theory, the economic impact of an increase in government purchases should be the same whether it is financed by borrowing or by reducing a budget surplus. In practice, the two courses may differ in their effect on business investment decisions; supposedly, the likelihood of an adverse effect on private investment would be greater if the budget were placed in the red than if merely the surplus were reduced. This difference would doubtless be less now than in the 'thirties when the bogey of deficit financing had greater influence.

Aside from a psychological reaction of this sort, it might be asked whether a loan-financed expenditure program would reduce private spending through its effects on the availability of funds. One would not expect an outcome of this sort in the postwar economy, however, since the supply of liquid assets is redundant by most standards.[7] The effect of government borrowing on the availability of bank credit cannot be of any real significance as long as banks are able to secure reserves at will by selling government securities in a guaranteed market; nor should the effect on the availability of nonbank funds be of serious concern since government borrowings flow back to the economy as the money is spent. Only in a situation where a government borrowing campaign is specifically directed at stimulating small savings or at diverting funds from other spending purposes is it likely to contribute to an anti-inflation objective. Of course, to the extent that government securities are sold to banks, quite the opposite result is achieved insofar as there is an inflationary expansion of the money supply.

A negative change in private investment would tend to offset the effects of the additional government spending. The increase in personal incomes generated by the expenditure program would be reduced and the net effect on consumer expenditures would be correspondingly diminished.

In the postwar situation, however, it seems more realistic to expect the induced change in private investment to be a positive magnitude, since additional government spending for military and related programs tends to bolster the general business situation. Thus, government spending would be augmented by larger private investment and the chain of consumer respendings would be correspondingly inflated. An original outlay of, say, $5 billion for government programs, plus, for example, a $2 billion expansion in private investment, might well wind up as a $21 billion addition to aggregate demand.[8]

[6] In the interest of simplifying the presentation, no allowance is made at this point for the fact that part of the additional spending would be automatically covered by the higher yield of existing taxes as total income is raised.

[7] See the author's article, "The Expanded Money Supply and Economic Activity," *Survey of Current Business*, May, 1946, pp. 8, ff.

[8] The multiplier of 3 which is used in this and succeeding examples is the approximate value derived from the national income and product statistics for the 1929-1940 period. It is used only for illustrative purposes; more refined calculations would be

Aside from any stimulative effects on private investment, a policy of increasing the expenditure side of the budget without levying additional taxes would still be highly inflationary as long as the slack in the economy is maintained at a minimum. The 3 to 1 ratio serves as a rough indicator of the magnitude of the expansionary effect on total public and private outlay.

Example 2.—Balanced Budget

A more orthodox budget policy would call for tax increases in line with the increase in government expenditures. It has already been demonstrated that this would not necessarily be a noninflationary policy; in all likelihood, it would still have inflationary effects. Nevertheless, the balanced budget approach would be a decided improvement over loan financing because (1) the stimulative effect on private investment would tend to be smaller and, in some cases, the effect might well be negative, and (2) the new taxes would absorb income available for consumer spending.

In order to analyze the balanced-budget approach in further detail, it is desirable to treat separately the investment and consumption effects. Clearly, if private investment is curtailed, either because the new taxes reduce the incentive to invest or absorb funds that would otherwise have been invested, a negative multiplier chain becomes operative and the inflationary effects of the government outlay tends to be offset. Under balanced-budget conditions, the consumption-reducing effects of higher taxes would be an additional influence in this same direction. A complete offset would thus be possible, even though the decline in investment were substantially smaller than the increase in the government budget.[9] Under the loan-financing case just considered, these two opposing changes would need to be about equal in size.

In the event that the effect on private investment is negligible, the inflationary effects of the balanced-budget approach will hinge on the extent to which the tax-financed expenditure program is neutral, stimulative, or repressive in its effects on consumption. It would be neutral if the individuals who pay the additional taxes have the same consumption and savings habits as the recipients of the incremental expenditures. It would be stimulative if the taxpayers as a group spend less, on the average, than the recipients of the expenditures, and repressive if the reverse were true.

A neutral financing policy would leave total consumer spending unchanged, although aggregate public and private demand would be raised by the original amount of government spending. This is the general case, already described, where the multiplier is one, despite the absence of loan financing. A stimulative policy would raise consumer spending and a repressive policy would lower it.

It is the latter possibility which suggests another opportunity for noninflationary financing, namely, the possibility of adopting a tax policy which results in a redistribution of income

necessary to determine its applicability to the postwar situation. As noted in the appendix, this particular formulation of the multiplier is a variant of the definition which is generally adopted. It can be defined as the reciprocal of one minus the ratio of consumer expenditures to gross national product minus tax payments.

[9] See section 5 in the appendix for an algebraic formulation of the necessary relationships.

from high-consuming (low-income) to low-consuming (high-income) groups. The requirements for a noninflationary financing policy of this type are illustrated in Table 1. Three assumptions are involved in these computations: (1) the incremental expenditures and taxes are in balance; (2) private investment outlays are unchanged; and (3) the multiplier is 3. The reader is referred to the appendix for the algebraic formula underlying the computations.

In brief, the problem is to devise a tax program which will curtail consumption by a larger amount than the new government expenditures will add to it. According to the computations summarized in the table, if one-fourth of the new expenditures will be reflected in increased consumer spending, then 58 per cent of the new taxes must be paid at the expense of such spending. And if the former fraction is raised to three-fourths, then the tax-induced decrease in consumption would have to be even larger than the revenue yield.

What is the likelihood of the occurrence of any of these combinations of figures? On the expenditure side, it may be noted that if government purchases are subject to the same proportion of "leakages" into corporate and consumer savings as are the purchases for the economy as a whole, a value of .67 would be indicated as the proportion which will be reflected in increased consumer spending. This value, of course, corresponds to the crude multiplier of 3 which has already been used.

On the tax side, we are faced with the problem that the impact on savings and consumption will vary substantially with different types of taxes. Even for a regressive tax, however, a significant proportion will still be paid out of savings. The Federal Reserve survey of consumer finances indicated that about

TABLE 1

Illustrative Requirements for a Noninflationary Fiscal Policy under the Balanced-Budget Assumption *

Proportion of added government expenditures which will be reflected in increased consumer spending	Necessary distribution of source of added tax payments	
	Decrease in consumption	Decrease in saving
.25	.58	.42
.50	.83	.17
.75	1.08	—.08

* Balanced-budget assumption applies only to the new expenditure program. The multiplier effect of consumption respending is assumed to be 3. No allowance is made for effects on private investment.

9 per cent of money income was saved in 1947.[10] This figure, however, is not a satisfactory guide to the problem at hand, for certain obvious reasons: (1) the 9 per cent figure is an *average* propensity to save and is below the *marginal* propensity, which would be more applicable to the problem at hand; (2) the 9 per cent is weighted down by sizable negative savings for a large group of consumers; (3) there is a difficult problem of making allowance for time lags in the adjustment of consumer spending and saving to a new tax. If the marginal propensity to save by income groups is used as a guide to the impact of a new tax, the available statistics suggest that a tax which is distributed among income groups in proportion to the amount of money expenditures for consumption would be paid out of savings to the extent of 20 to 25 per cent in 1947. For a less regressive type of tax, the proportion paid out of savings would be substantially higher.

[10] See *Federal Reserve Bulletin*, XXXIV (June, July, and August, 1948).

These statistical approximations illustrate the difficulty of formulating a noninflationary financing policy within the framework of a balanced budget, unless reliance is placed upon the adverse effects on private investment. With a stimulative effect on private investment, the balanced-budget framework would be intolerable from the standpoint of inflation control. Only a tax surplus could provide the necessary fiscal offset.

Example 3.—Budget Surplus

Still a third budgetary course is provided by the possibility of levying additional taxes which will more than pay for the incremental expenditures. If the surplus thus created is sufficiently large, the inflationary impact of the expenditure program could be checked. The important variables to be considered in this example are (1) the effect on private investment, (2) the character of the expenditure program, which will determine the induced effect on consumption, (3) the kind of taxes levied, and (4) the amount of revenue obtained.

With respect to the first of these, the opportunity for a decline in private investment which would compensate for the additional government purchases would ordinarily be greater the larger the increase in taxes. New taxes will affect both investment incentives and the availability of funds. From this standpoint, therefore, the budget surplus approach offers distinct advantages as a method of noninflationary financing.

The mathematical formulation followed in the preceding example provides a means of illustrating consistent combinations of values for the remaining three variables, given the objective of a noninflationary policy. These values are shown in Table 2. For example, if it is estimated that one-half of the added government expenditures will reappear as additional consumer spending, the required amount of additional taxes (expressed as percentages of the added government expenditures) would be:

333 per cent, if one-fourth of the new taxes were paid at the expense of consumption;

167 per cent, if one-half the new taxes were paid at the expense of consumption;

111 per cent, if three-fourths of the new taxes were paid at the expense of consumption.

The final figure in the second row of the table suggests that a surplus would not be required in this situation, provided that the taxes induced a dollar-for-dollar reduction in consumer spending—a wholly unrealistic proviso. The general rule, of course, is that the more repressive the tax policy adopted, the smaller the required surplus. These computations, however, do not allow for any adverse effects on private

TABLE 2

ILLUSTRATIVE REQUIREMENTS FOR A NONINFLATIONARY FISCAL POLICY: NECESSARY RATIO OF ADDED REVENUES TO ADDED EXPENDITURES *

Proportion of added government expenditures which will be reflected in increased consumer spending	Ratio of revenues to expenses, assuming that proportion of added taxes paid at the expense of consumer spending is as follows:			
	.25	.50	.75	1.00
.25	2.33	1.17	.78	.58
.50	3.33	1.67	1.11	.83
.75	4.33	2.17	1.44	1.08

* Computations assume that the multiplier effect of consumption respending is equal to 3. No allowance is made for effects on private investment.

investment. Such effects, of course, would lower the tax requirements.

Certain combinations of figures in the table apply to a neutral expenditure-taxation policy, i.e., a policy which involves expenditures and taxes with equal proportionate effects on consumer spending. In these cases, the amount of taxes required to check the inflationary pressure of added government expenditures would range downward from 233 per cent of the amount of added spending, if the expenditures and taxes had only a small relative effect on consumption, to 144 per cent if the effect were substantial. This illustrates a point made at the outset of this paper, namely, that a financing policy which is neutral in its distributional aspects might still be inflationary, unless it were associated with a sizable budget surplus.

SELECTION OF APPROPRIATE POLICY

Two separate decisions are involved in the process of formulating an appropriate policy for financing additional government expenditures in a period of high employment and general pressure on the price level: (1) How should the necessary contraction in aggregate private spending be distributed between consumption and investment? (2) What is the best means of accomplishing this objective? By way of explanation it should be noted that the first question refers to the net result of the combined revenue-expenditure program that is adopted, rather than merely to the tax-induced contraction in private spending. The second question should be interpreted so as to embrace both the types and rates of taxes and the various nontax instruments of government economic policy.

There is a simple reason why a decision on the first question is more likely to recommend that the cut be made in consumption rather than in investment. With consumption running at an annual rate of about $180 billion and gross private domestic investment at $40 billion, an expansion of, say, $5 billion in the government program would necessitate a less than 3 per cent contraction in consumption and a 12.5 per cent contraction in investment. On the other hand, one must take account of the more volatile nature of investment spending; changes in consumption spending are typically associated with larger relative changes in investment.

Basically, of course, the decision should depend on where there is more "fat" in the economy, in the consumption or in the investment sector. This consideration also seems to recommend the consumption sector to bear the brunt of the contraction in private spending, although investment in recreational facilities and the like should not be ignored as a candidate for curtailment. In a period of high income and employment there is bound to be considerable leeway for reducing consumer spending without encroaching upon essential living standards. Moreover, both the requirements of national security and the desirability of filling the void which is the legacy of the lean investment period of the 'thirties and the late war years point to the need for continued high investment volume. Consumer spending for durable goods, including residential construction, represents another area where there is a backlog to be worked off.

An additional set of factors, however, weighs heavily on the opposite side of

the scale. The inflationary forces have been considerably stronger in the durable goods area of the economy than in the nondurable goods area. Since a stepped-up defense program has its heaviest impact in the former sector, it might be argued that the anti-inflation objective would be best served if the offsetting reduction were made in private spending for durable goods.

If it were agreed that this were the most desirable approach to adopt, then a strong case could be made for relying upon nontax measures. It would be extremely difficult to devise a tax which would have its primary impact on durable goods spending for less essential purposes and at the same time satisfy other criteria for desirable revenue measures. A system of selective excise taxes would appear to have much to recommend it from the standpoint of deterring certain types of purchases, but it would also have important drawbacks such as its limited revenue potentialities, the impossibility of differentiating according to essentiality, the difficulty of taxing secondhand goods, and the high tax rate that would be needed for goods where demand backlogs are large. A program for allocating raw material supplies and rationing production among the more essential users could accomplish the desirable objective in a much more effective manner.

A system of direct controls would make possible a selective curtailment of outlays for producers' plant and equipment, whereas tax measures would have haphazard effects. There would be no certainty that a tax which impinged upon investment incentives would not shut off some of the more urgent plant expansion and modernization programs.

It should be stressed that an anti-inflation program which focused on the curtailment of business and consumer demand for durable goods need not conflict with the various considerations favoring continued large additions to the nation's stock of such goods. There would not be any conflict provided the curtailment program did not interfere with the achievement of maximum production of these goods. As long as productive capacity and materials supplies are deficient at some stage of production, government intervention might serve a useful purpose in channeling output to the high priority users.

The task of curtailing general consumer purchasing, on the other hand, might well be relegated to the individual income tax. The selection of an acceptable pattern of normal and surtax rates always is a difficult one involving the amalgam of social and political considerations entering into income distribution problems. To the extent that it is decided that the reduction in spending should be made largely at upper-income levels, the excess of revenues over expenditures that would be needed to effect a given reduction in consumer spending would be considerably larger than if a less progressive rate structure were selected. This is readily apparent from the pattern of revenue-expenditure ratios shown in Table 2. This requirement illustrates the well-known conflict between anti-inflation objectives and tax progression. A revenue surplus, however, would do more than restrain the immediate inflationary forces, since it would offer long-run advantages in the form of lower carrying charges on the public debt.

A variety of other taxes, such as the corporate income tax, might well have

a place in the financing program. Whether or not such taxes are needed as direct anti-inflation measures, they offer possibilities of satisfying various social, political, and fiscal objectives. It may be noted that taxes which are desired for the latter reasons might have an important though indirect effect on the inflation problem. Higher corporate income taxes, for example, have been proposed as a means of slowing down the wage-price spiral, on the ground that the existence of large after-tax profits has lent support to wage demands. To counter this proposal it is argued that a higher tax would weaken employer resistance to wage demands, since the government would in effect pay a large share of the new wage bill. Arguments of this sort involve human more than economic relationships. Their relevance to tax policy formulation should not be minimized.

Finally, one should not overlook the purely fiscal objective. It is a cardinal principle of public finance that a tax program to cover current requirements and debt retirement should always be pursued as vigorously as is consistent with the effective operation of the economy.

APPENDIX [1]

The necessary conditions for financing an increase in government expenditures for goods and services in a manner which will not add to total public and private outlay may be formulated in simplified algebraic terms in the following manner:

$$E + k\,(I + aE - bT) = 0$$

where

E is the additional government expenditure on current output;

I is the induced change (positive or negative) in private investment;

a is the marginal propensity to consume (out of income after taxes) of the recipients of E;

T is the additional tax revenue (from existing and new legislation);

b is the marginal propensity to consume (out of income after taxes) of those who pay T;

k is the multiplier applicable to a change in private expenditures on consumption or investment, based upon the marginal propensity to consume (out of income after taxes) for the community as a whole.

This equation states that the net effect on aggregate public and private spending will equal (1) the original addition to government purchases, plus (2) k times the change in investment, which may either be positive or negative, plus (3) k times the induced change in the consumption spending of those who receive additional income, minus (4) k times the induced change in the spending of those who meet the increased tax bill. In order to satisfy the equation, the terms must balance out to zero.

An advantage of formulating the problem in the above manner is that it permits a differentiation between the marginal propensity to consume of the community at large, which underlies k, and the respective propensities (a and b) of the groups whose incomes are directly affected by the governmental programs. Of particular importance for the present problem is that this formulation makes it possible to contrast alternative tax policies.

Since the values of E and aE are assumed to be positive, the offsetting influ-

[1] The algebraic presentation in this appendix is an adaption of R. A. Musgrave's equations in "Alternative Budget Policies for Full Employment," *American Economic Review*, XXXV (June, 1945), 387-400.

ences can have their source either in a negative change in I or in the value of bT. Should the change in I be positive, the burden of offsetting the expansionary influences would rest solely with bT. The value of the latter term depends upon the type of taxes imposed, since b would ordinarily be different for different taxes, and upon the amount of revenue that is obtained. Various simplified noninflationary financing policies may be illustrated.

1. If sole reliance for counteracting the stimulative influence of additional government spending is placed on a negative change in I, so that $T = O$, the equation will be satisfied if the reduction in private investment equals the increase in the government program, provided that the marginal propensity to consume of the recipients of government payments equals the marginal propensity to consume of the community at large. In algebraic terms these conditions [2] are $I = -E$, and

$a = \frac{k-1}{k}$. In addition, of course, $T = O$.

The proof of this proposition can be demonstrated by substituting the required values for a and T in the original equation and solving for I, as follows:

$$E + k\left(I + \frac{k-1}{k}E\right) = O$$
$$E + kI + kE - E = O$$
$$kI = -kE$$
$$I = -E$$

2. It follows from the above that if tax revenues rose so that bT were greater than zero, I could be smaller than $-E$. In the simplified case where $I = O$, a noninflationary policy would be possible if $bT = E$ and the marginal propensities to consume of the recipients of government payments and of the community at large are equal

(i.e., $a = \frac{k-1}{k}$). Substituting for I and a and solving for bT, we obtain the following:

$$E + k\left(\frac{k-1}{k}E - bT\right) = O$$
$$E + (k-1)E - kbT = O$$
$$E + kE - E - kbT = O$$
$$-kbT = -kE$$
$$bT = E$$

Of necessity, b must be less than one. The preceding equation, therefore, demonstrates the need for a tax surplus in the assumed situation. The surplus requirement also is considered in 4 below.

In the event that there is a divergence between the respective propensities of the recipients of government payments and of the community at large, the necessary condition for bT are:

$$bT = \frac{E}{k} + aE$$

3. Under the balanced budget approach, where $T = E$, whether or not the financing policy is inflationary will hinge on the induced change in investment and on the values of a and b. If the further simplification is made that $I = O$, then it will be necessary for b to exceed a by an amount equal to the reciprocal of k. By substitution,

$$E + k(aE - bE) = O$$
$$E + kE(a - b) = O$$
$$a - b = -\frac{1}{k}$$
$$b - a = \frac{1}{k}$$

The balanced budget requirement, in other words, is not sufficient to insure a noninflationary policy.

4. Conversely, a "neutral" expenditure and tax program, in which the new taxes were so designed that the tax-induced curtailment of consumption exactly counterbalanced the stimulus to consumption generated by the additional government spending, would not be sufficient, even though taxes and revenues were held in balance. For example, if $a = b$ and $I = O$,

[2] The relationship between a and k is derived from the familiar proposition that the multiplier must equal the reciprocal of 1 minus the propensity to consume; that is, $k = \frac{1}{1-a}$. Solving the equation for a gives the expression in the text.

a tax surplus $(T - E)$ of the following magnitude would be necessary:

$$E + k\,(aE - aT) = 0$$
$$-kaT = -E - kaE$$
$$T = \frac{E}{ka} + E$$
$$T - E = \frac{E}{ka}$$

In the above case, the requisite surplus would be smaller, the larger the values for k, a, and b. Where $a = \frac{k-1}{k} = b$, it can be readily shown that the above result is equivalent to that obtained in 2 above.

5. Under the joint assumptions of a balanced budget $(T = E)$ and a "neutral" expenditure and tax program $(a = b)$, realization of the objective of noninflationary finance would require a negative change in investment in an amount equal to the reciprocal of the multiplier times the added government expenditure. By substitution,

$$E + k\,(I + aE - aE) = 0$$
$$E + kI = 0$$
$$I = -\frac{E}{k}$$

6. Finally, the situation might be examined where there is a stimulative effect on private investment as well as on consumption. The result in such a case is the same as if government spending were raised by the amount of the additional investment, provided that the simplification is made that government spending and investment outlays are equally stimulating in their effects on consumption. For example, if $a = \frac{k-1}{k}$, then,

$$E + kI + (k-1)\,E - kbt = 0$$
$$E + kI + kE - E - kbT = 0$$
$$I + E - bt = 0$$
$$bt = E + I$$

The preceding examples are in the nature of limiting cases which are designed to illustrate various methods of approaching the problem of designing a noninflationary financing policy. In actual practice, of course, a wide range of intermediate policies would be possible.

TAX ADMINISTRATION IN MEXICO

W. T. SHERWOOD *

IN VIEW of my forty-odd years of service with the Federal Government —most of them with the Bureau of Internal Revenue—it is inevitable that the experience thus obtained should serve as a frame of reference for my reactions to the problems of tax administration in Mexico. Accordingly, in the remarks that follow I shall jump from one side of the Rio Grande to the other without regard for customs officials or immigration officers.

During my period of service in the Bureau of Internal Revenue we were constantly making efforts to obtain more funds for enforcement work. We have always needed more men, but the compensation scales have never been adequate to enable the Government to retain many of the more able ones who have been attracted to private employment by the opportunities for greater earnings. Yet many very able men have remained in the service because of their interest in the work and their desire to contribute to good government. By and large, there never has been a more able government organization than the United States Bureau of Internal Revenue. It was my good fortune to enjoy a more or less close working relationship with all of the Commissioners of Internal Revenue from the Hon. Daniel C. Roper to the present incumbent, the Hon. George J. Schoeneman. Without exception and regardless of political affiliations, these men have fully appreciated the absolute necessity of having able assistants in key management stations and of maintaining and improving the quality of the entire personnel of the Bureau.

Importance of Good Staff in Tax Administration

The job of collecting taxes is a difficult one at best, and with the high rates now in force the collection of the individual income tax can be done passably well only if the Bureau staff is adequate both in size and professional competence. Income taxation in the United States did not reach the masses until after the onset of World War II. Then the broadening of the base and the stepping up of rates came simultaneously. Suddenly the "customer list" of the Bureau increased from a few million to more than 50 million persons. Nevertheless, because the basic structure of the Bureau was solid, and because its *esprit de corps* had been carefully nurtured by both Democratic and Republican administrations, there was no breakdown in the service and an amazing task was somehow performed. On the front line of this undertaking, of course were the field groups.

The primary explanation of the fact that we in the United States have had reasonably good administration is directly traceable to the fine group of

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men and women who constitute the Bureau of Internal Revenue. It is the clerk in the cashier's cage in the collector's office, the deputy collectors, the clerical aides in the field offices who contact the public, the revenue agent who visits the taxpayer, the storekeeper-gauger, the special agent, and all the others who operate in the home towns of the taxpayers that maintain respect for the revenue service in this country. These people demonstrate the wisdom of maintaining the basic career character of the service. No individual or group of individuals can build an efficient and effective organization if the underlying employee structure is fundamentally weak or defective.

The personnel situation in Mexico is very different. At my first meeting with the men with whom I was to work one of Mexico's cabinet members remarked, "Mexico is not the United States." This was fair warning that a necessary initial step was an appraisal of the actual opportunities for making progress. It was not the first time, however, that I faced the problem of undertaking to fix goals in the light of the caliber and qualifications of the persons with whom I was to be associated. One of the most important—perhaps the most important—of the duties of an administrative officer is to find the man needed in a particular spot. In our own Federal service, the officer is permitted a reasonable latitude in this respect. So long as his selections are based upon honest regard for merit and ability he is seldom hampered by outside interference. This cannot be said of Mexico.

I met and worked with some very earnest, able men in Mexico City. They were trying manfully to build a sound administrative organization, but they were starting almost from scratch. If given the time and the necessary funds and personnel, they can do the job.

While in the Bureau at Washington I met representatives of many Latin American and Eastern Hemisphere countries. Generally they had come to study our plans and methods of administration, and efforts were made to indoctrinate them in regard to the broad management plans of the Bureau. Yet I have entertained a suspicion over the years that the method employed so confused the delegated persons that what they took back was practically useless to the interested countries. Although I spent two months in Mexico, I confess that my knowledge of its system of taxation and the administrative plan of operation is, to say the least, quite scant. In undertaking to provide advice based upon my experience in the United States, it seemed that a detailed inquiry into the "philosophy" of the Mexican tax system would not be a fruitful use of time. Since I do not speak Spanish, the slow motion and uncertainty of the translation process were impediments to exploratory discussion.

Detailed charts of the existing organization were available. No small portion of the efforts of the administrative officers must have been devoted to the development of alluring word and graphic descriptions of ideal layouts. Yet attempts to follow the chart picture to the actual operating units were often disappointing and useless.

Problems of Tax Administration in Mexico

The principal asset the Mexican government possesses for improving tax

administration is the group of able men who are nominally in charge of the offices located in Mexico City. The primary difficulty is that these men have almost no real opportunity to staff either the Mexico City or field offices with the type of personnel essential to good administration. It is possible to identify men of fine character who within a reasonable period could give to Mexico the kind of administration it needs to obtain and maintain the respect of its citizens for taxing authorities. There are individuals of long service, seasoned to the vicissitudes of Mexican political changes, and also younger men of ideals with the will to make sacrifices for the benefit of the whole people. That is the best combination for working toward better management. Furthermore, there are no "wise men" available in other countries to work miracles that will overcome the basic deficiencies of lack of adequate compensation to employees and of the practice of appointing employees on the basis of political or union affiliations. Since the revolution, less than three decades ago, Mexico has made progress, and there seems to be a real disposition to continue the efforts to reduce illiteracy. But so little is needed to make life bearable and even attractive that it will be more difficult to interest the impoverished citizens in the affairs of government than it is in other areas.

There was much interest among the top-level Mexican officials in the development of what they thought of as a "secret service." Actually they had in mind an organization like the Intelligence Unit of the United States Bureau of Internal Revenue. Evidently this group was to be organized in the hope that it would be a cure-all for the ailments of tax administration. Certainly an intelligence unit is needed, but such a unit cannot be effective unless there is an adequate organization to carry on audit and investigative work, unless there is a complete change in the scheme of recruiting employees responsible for tax collection, and unless an effort is made to obtain people who possess the necessary character and professional equipment, particularly in the accounting field.

According to comments of persons who were in position to know, a principal difficulty in Mexico has been to prevail upon those charged with the duty of collecting taxes to account for the moneys paid to them. A project was under way to have taxes collected through the banking system and to divide the country into fiscal zones to the end that payments in the field areas could be better protected. Advantages to the fiscal accounting will doubtless result if some such arrangements are completed, but it may be doubted whether the underlying problem of honest collections can be solved in this fashion. Here again it is in point to register the suggestion that the basic remedy is better-compensated employees of career character, and the complete divorce of the service from both political association and union domination. The unions appear to have positive authority in determining who shall be appointed as well as in controlling the progress in the service of those appointed. The participation of union leaders in personnel management represents a serious handicap to the administrators' efforts.

Another weakness of the personnel situation in Mexico is the complete lack

of accountants associated with the over-all management effort. In the tax organization, there are engineers, lawyers, and economists, but almost no accountants. I was advised that it was practically impossible for the Government to hire accountants. Apparently the accountants were making more money working for the taxpayers. If the widespread street comment was based on fact—that generally the taxpayers maintained two sets of books, one for themselves and one for the Government—it is not difficult to understand why. Indeed it was said that occasionally three sets of books were maintained, the third set for the shareholders in cases where the managers were attempting to obtain a larger share of the profits of the business.

A goodly number of capable engineers are found in prominent administrative posts. Some lawyers also occupy administrative positions. But, at least in the Federal District headquarters office, the economists predominated in the professional groups. Therefore, most of the adjustments proposed in connection with the enforcement gesture—and the word " gesture " is used advisedly—were based on so-called economic studies. An economic study in this respect usually consists of assembling the declarations of a group of taxpayers of similar characteristics and averaging the tax reported; the result, the mean reported liability of the group, then becomes the acceptable tax for all members of the group. I was informed that such a study had been the basis for an official amnesty proposal to a large group of taxpayers, and that as a result a number of millions of pesos was paid into the Treasury. Against the background of our ideas in this country, such an arrangement would be completely destructive of Bureau morale. I understood that this particular decision was made at a level somewhat higher than the tax administrators. It was easy to gain the impression that it was common practice for taxpayers to appeal their cases to the secretariat and even to the executive. Certainly the visiting lists of the Secretary of the Treasury were amazing. The lines formed in the early morning and the large waiting rooms were always well filled.

Another source of serious administrative difficulty is the fact that much of the small business of Mexico is conducted without records. The pants pocket is often the cash register for fairly substantial business undertakings. Many concerns operate without an established business address. Consequently, even though the Mexican tax base is nominally broad, it appears that in actual practice some few thousand taxpayers are the source of nearly all Federal revenue.

Even on the basis of inadequate statistical data, it is clear that the state has not been getting the tax to which it is entitled from the professional groups. If the number of persons registered in the Federal District for purposes of professional licensing is compared with the number filing tax returns, the second figure is shockingly small. Also, the average income reported by those who did file returns is absurdly low. Even in the United States this group is uncommonly difficult to reach, but in Mexico the situation must be characterized as well-nigh shameful.

The escape of the self-employed from the income tax results in a grave discrimination against wage earners who

are subject to the so-called withholding tax. This tax is in fact a pay roll tax. The liability does not depend upon an annual accounting; the amounts withheld each pay roll period are retained in full by the states. As the employees subject to this tax become better informed there will probably arise a feeling of resentment against those self-employed persons who escape practically all income tax even though their incomes greatly exceed the annual earnings of persons subject to the pay roll tax.

The so-called mercantile tax that has been introduced only recently is in fact a levy based upon gross receipts. It was designed to be administered and shared jointly by the Federal Government and the constituent states. Certainly the idea has some appeal. I was informed, however, that the commission authorized to conduct negotiations had made only small progress in reaching agreement with the governors of the several states.

Recommendations

Organization. — After conferring with the chief tax officials for several weeks, on July 7, 1948, I submitted the following specific proposals:

1. Consolidation under one head of the several groups in Mexico City engaged in tax work;
2. Organization of a central management staff;
3. Organization of an intelligence group;
4. Organization of a forms committee.

In addition, I discussed the need to supply the Mexican bureau with sufficient funds, adequate salary scales, and protection from improper outside interference. It appears that the executive in Mexico is free to establish the budget it considers essential to the welfare of the state, and that the legislature exercises no authority in this respect. This circumstance may be viewed from one standpoint as offering a favorable opportunity for accelerating progress in tax administration.

On July 22, 1948, I again emphasized the need to consolidate all operating groups into one strong bureau, and recommended that the head office in Mexico City restrict its operations to supervision and management, and that it begin to give the taxpayers more and better information regarding their country's tax system. Also I urged that the field offices be restaffed and that a large measure of responsibility be delegated to the field officers. Once again I stressed the need to obtain qualified personnel, and made the off-the-record observation that no effort would be better than one undertaken with ineffective personnel.

One of the principal handicaps with which even qualified personnel must cope in Mexico is a devotion to detail that is simply beyond description. The elimination of nonessential paper work was urged, including the multiple checking of individual taxpayer accounts by other Treasury groups. I suggested that qualified men be sent to the United States to study the collection accounting methods employed here.

Training. — No systematic effort is made to train employees, and it was suggested that a division be created to teach the employees the essentials of the job. In our own Bureau all those engaged in enforcement work are required to take "refresher" training and thus keep abreast of the changes in statutes. The Training Division offers oppor-

tunity for those with incomplete educational background to equip themselves for more responsible participation in the tax-enforcement effort. In the days following World War I the Training Division was well-nigh indispensable to the building of the Bureau of Internal Revenue. Even at that time in this country it was necessary to give employees special training in tax accounting. Mexico's problem in this respect is much more serious, and thus far no effort has been made to develop a Government training program. I provided copies of the training materials used in this country, and there appeared to be a genuine will to get started.

Auditing. — A " gesture " audit is now conducted from Mexico City or, perhaps more accurately, *in* Mexico City. It appears that taxpayers are asked to send their books to the audit division in Mexico City, and that often the books are retained for months or even years. It is inconceivable that effective enforcement could be attained by such procedures, and it is impossible to understand how a business whose books were honestly kept could continue to function without serious handicap under such absurd conditions. I felt obligated to suggest that no enforcement effort at all would be preferable to one conducted in such an intolerable fashion.

The audit group in Mexico City is handicapped by extreme specialization, a fault that plagued our early efforts in this country. Where there is but little complexity of the taxing plan, as is the case in Mexico, overspecialization is simply indication of mediocrity of staffing. It provides a defensive wall behind which both management and staff can retire. Responsible Mexican officials are keenly aware of the need to reconstitute the enforcement efforts and to undertake the work through properly equipped field offices. By reason of past experience, however, they hesitate to establish real responsibility in the field offices until they are certain that the management of these offices will be in the hands of qualified men who are not selected on a political basis.

Intelligence and Enforcement. — In the recommendations submitted on July 22, I discussed again the need of Mexico for an intelligence unit, reasserting that the first responsibility of such a unit would be to aid in staffing by investigating prospective appointees. I emphasized that an intelligence unit could not be the complete answer to the enforcement problem; rather, that it would be definitely impotent unless the entire administrative organization was reconstituted as an effective operating group. Further, I contended that a Mexican counterpart of a well-managed collector's office in the United States was needed as the contact office with the public, and that such an office is probably the most necessary of all constituent divisions in the development of an adequate tax enforcement unit. Criminal sanctions should seldom be attempted until there has been an earnest and sustained program for educating the people as to their tax responsibilities. This is particularly self-evident when the tax base is broad. Mexico's problem is especially difficult because the publicity mediums so common to our country are not available there, and also because so many citizens of that country are uneducated and cannot be expected to inform themselves regarding their responsibilities to government. Prob-

ably the most priceless asset to tax administration in the United States is the almost universal voluntary response of the citizens to the taxing statutes.

The consequences of the Mexican enforcement work were not available, in terms either of total assessments or achievements of individual employees. A statistical and research group was included in the organization chart, but its principal undertaking was to develop a "taxpayer list." The method employed was to compile lists of names of persons who filed income tax returns and of those who filed returns reporting liability under the so-called mercantile tax. The purpose of the list was to enable the Mexico City office to check the receipts reported as paid by those who filed returns. This type of procedure is so much in conflict with our own practice, in which collectors have full responsibility for locating all persons liable to taxes, that I urged repeatedly the advantages of the method used so successfully in the United States. It became clear, however, that with their past experience, the Mexican administrators could not be convinced that the maintenance of a control list in Mexico City was not absolutely essential to the tax collection effort.

Summary of Recommendations.—On August 12, 1948, after nearly two months of almost constant conferences, I summarized my conclusions. And then, just as after the first two weeks of my visit, I emphasized that the imperative prerequisite to better tax administration in Mexico is better-equipped personnel. The men in charge of the work are entirely competent to carry on an effective administration. They have the ability and the disposition to do the job. But they are sorely deficient in supporting groups both in Mexico City and the field, particularly in the field. Until Mexico is able to hire sufficiently qualified people and to pay adequate salaries there will be no substantial improvement in administration. Methods will not substitute for proper personnel. An ideal administrative plan is no better than an inferior one unless it is in the hands of capable employees.

But there is a will to do among those who are to administer taxation in Mexico. They are alive to the handicaps under which they have to labor. They had the patience to carry on through the formative years, and with the support of the top-level officers they will yet provide Mexico with good administration.

Supplementary to, and in further support of, emphasis on the importance of a solution to the personnel problem, I strongly advocated:

1. Consolidation under one head of all groups engaging in tax enforcement work;
2. Real authority to the Commissioner of Internal Revenue;
3. Strong field offices to which would be delegated large areas of responsibility;
4. A strong management staff attached to the Commissioner's immediate office;
5. Elimination of unnecessary paper work;
6. Development of group and individual production records;
7. A forms committee and a public relations organization;
8. An intelligence unit;
9. A training plan.

I earnestly hope that these suggestions may be helpful to the men in charge of

the work in appraising the opportunities for giving Mexico a more satisfactory tax administration.

Conclusion

It would have been possible and easy to have confined this statement to discussion of methods employed in the gesture toward administration in Mexico. Or I might have compared our procedural rules with their Mexican counterparts. But these subjects seem to me to be of academic interest only—to have but little practical significance. Here as elsewhere, first things should come first. Accordingly, I have restricted my remarks to the matters that I believe are of prime importance in any attempt by Mexico to move upward to higher standards of tax administration. The whole weight of our own experience supports the conclusion that integrity and competence of staff must precede, not follow, refinements in administrative organization and procedures.

FEDERAL FINANCES IN 1948

RICHARD GOODE *

THE YEAR 1948 was a period of mixed economic and fiscal developments. Taken as whole, it appears to have been a year of continued inflation. Consumer prices averaged 7.5 per cent higher than in 1947, despite declines in the last quarter of 1948, especially in food items. Money national income and personal income rose more in 1948 than either industrial production or total civilian employment. But the progress of inflation was less rapid than in 1946 and 1947. Indeed, wholesale prices were slightly lower at the end of 1948 than they had been a year earlier.[1] There was some evidence that in the closing months of 1948 inflationary and deflationary forces were at least temporarily in approximate balance, with the government program the principal dynamic force.[2]

After the sharp decline of the immediate postwar years, Federal expenditures began to increase, and further increases were forecast by the President's budget submitted in January, 1949. A major tax reduction, enacted over the President's veto in April, 1948, reduced Federal receipts in the second half of 1948 below the previous year's level. An important technical tax revision bill passed the House of Representatives but did not reach the floor of the Senate. All of this took place in the setting of an active political campaign.

THE BUDGET

In the fiscal year ended June 30, 1948, total Federal budget expenditures were $33.8 billion; receipts were $42.2 billion. The resulting budget surplus of $8.4 billion was the largest on record. As compared with the fiscal year 1947, budget expenditures were $5.5 billion lower while receipts were $2.2 billion higher.

At the close of the calendar year 1948, expenditures for the fiscal year 1949—then half over—were estimated at $40.2 billion and receipts at $39.6 billion, leaving a deficit of $0.6 billion.[3]

The expected sharp change in the fiscal position of the Government between the fiscal years 1948 and 1949 was attributable to an expansion of most major expenditure programs and a decrease in revenues resulting from the reduction in tax rates in 1948. The change in the cash budget was smaller than in the regular budget. On a cash basis—with all noncash items and intragovernmental transactions eliminated and trust accounts consolidated with regular accounts—the excess of receipts over outlays was expected to drop from

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[1] The foregoing is based on data appearing in *Economic Indicators* (prepared for the Joint Committee on the Economic Report by the Council of Economic Advisers, 81st Cong., 1st sess.), February, 1949.

[2] *Survey of Current Business*, January, 1949, pp. 1-2.

[3] *Budget of the United States for the Fiscal Year Ending June 30, 1950*, Appendix 5, pp. 1397-99. The figures are on the revised basis described below.

$8.8 billion in the fiscal year 1948 to $2.8 billion in the fiscal year 1949.[4]

Legislative Budget

The Legislative Reorganization Act of 1946 set up a procedure intended to foster systematic Congressional consideration of the budget as a whole. The act provided for a legislative budget in which the Congress early each session would determine a ceiling on appropriations and expenditures, presumably in the light of expected revenues and economic conditions. In 1947, the Senate and House were unable to agree on a legislative budget, but in 1948 agreement was reached on a legislative budget for the fiscal year 1949 calling for a $2.5 billion reduction in the expenditures recommended by the President, assigning not less than $2.6 billion of the expected surplus to debt reduction, and supposedly leaving room for tax reduction.[5] There was, however, general dissatisfaction with, or indifference to, the legislative budget, and the experience of 1948 as well as of 1947 seems to warrant this attitude.[6]

Unfortunately, it is difficult to compare the legislative budget and the executive budget even for a completed fiscal year. Interested citizens and members of Congress are likely to become lost in a maze of technicalities having to do with expenditures, appropriations, contract authorizations, reappropriations, supplemental appropriations, and the like. The most readily understood and most significant concept is that of expenditures. The determination of expenditures, however, is to some extent a matter of accounting conventions, and during the calendar year 1948 changes were made in the handling of certain items which significantly affected the reported total of budget expenditures.

After adjustment for accounting changes, it appears that in January, 1949, the President's estimate of expenditures for the fiscal year 1949 exceeded the ceiling set in the legislative budget by approximately $6.5 billion. With allowance for accounting changes, the President's estimate at the middle of the fiscal year 1949 exceeded his original budget estimate by some $4 billion, whereas the legislative budget had proposed a reduction of $2.5 billion. But it should be noted that the President's estimates of January, 1949, contemplated additional Congressional authorizations to spend some $2 billion for the fiscal year 1949, some of which may not be granted.[7]

It appears, therefore, that neither the President's original budget estimates nor the legislative budget recommendations provided a safe guide for revenue legislation during the calendar year 1948. In view of the confusing nature of the technical matters involved and the state of political feeling in a campaign year, it is perhaps not surprising

[4] *Ibid.*, p. A123.

[5] S. Con. Res. 42; H. Res. 485, 80th Cong., 2d sess.; *Congressional Record*, 94 (February 18, 1948), 1400-08; *ibid.*, (February 27, 1948), 1875-87.

[6] For accounts of the proceedings of both 1947 and 1948, see Avery Leiserson, "Coordination of Federal Budgetary and Appropriations Procedures under the Legislative Reorganization Act of 1946," *National Tax Journal*, I (June, 1948), 118-126; Jesse V. Burkhead, "Federal Budgetary Developments: 1947-48," *Public Administration Review*, VIII (Autumn, 1948), 267-275.

[7] Adjustments made on the basis of memorandum items in *Budget for the Fiscal Year 1950*, p. 1399. See also *ibid.*, p. M 70; *Budget for the Fiscal Year 1949*; *Statement of the President Reviewing the 1949 Budget* (August 15, 1948), Table 9.

TABLE 1

FEDERAL BUDGET RECEIPTS AND EXPENDITURES, REFUNDS OF RECEIPTS, AND CAPITAL TRANSFERS, 1941-48

(In millions of dollars)

Fiscal Year	Refunds of Receipts	Capital Transfers	Budget Receipts		Budget Expenditures	
			Old Basis	New Basis	Old Basis	New Basis
1941 ...	80	300	7,607	7,227	13,767	13,387
1942 ...	85	18	12,799	12,696	34,290	34,187
1943 ...	70	10	22,282	22,201	79,702	79,622
1944 ...	257	...	44,149	43,892	95,573	95,315
1945 ...	1,679	16	46,457	44,762	100,398	98,703
1946 ...	2,973	38	43,038	40,027	63,714	60,703
1947 ...	3,006	210	43,259	40,043	42,505	39,289
1948 ...	2,272	263	44,746	42,211	36,326	33,791
1949 [a] ..	2,709	791	43,080	39,580	43,680	40,180
1950 [a] ..	2,097	140	43,222	40,985	44,095	41,858

Source: *Budget for the Fiscal Year 1950*, pp. 1397-9; see also Treasury Department, Bureau of the Budget, General Accounting Office, press release, December 23, 1948.

[a] Estimates.

that charges and countercharges of bad faith were heard.[8]

The Budget Document and Government Accounting

Two significant changes in Government accounting made in 1948 related to refunds of receipts and to capital transfers of Government corporations.[9] In the past, overpayments of taxes were reported as receipts when collected and the refunds were treated as expenditures when made, with the result that both sides of the budget were inflated. With the adoption of the current-tax-payment plan for individual income tax, refunds grew to large amounts. Under the new procedure, announced December 23, 1948, refunds of receipts are shown in the Daily Treasury Statement and the budget document as deductions from receipts rather than as expenditures.

Prior to July 1, 1948, certain capital transfers of wholly owned Government corporations entered into the budget as both expenditures and receipts. For example, in July, 1948, the Reconstruction Finance Corporation, whose net receipts or expenditures are included in the budget, repaid $225 million to the Treasury to retire part of its capital stock. Under the old procedure, this item would have appeared both as an expenditure of the RFC and a miscellaneous receipt of the Treasury. As in the case of refunds, the old procedure would have inflated both sides of the budget by equal amounts. Under the new procedure, such capital transfers are excluded from the budget totals.

These accounting changes undoubtedly mean that the Daily Treasury Statement and the budget give a truer picture of the size of Government receipts and expenditures. Neither change affects the size of the Government deficit or surplus. Care must be used, however, in comparing budget re-

[8] See, for example, the report of contradictory claims made by Representatives John Taber and John D. Dingell, *New York Times*, August 15, 1948; also the contentions of Senators Styles Bridges and Eugene D. Millikin, *New York Times*, August 16, 1948.

[9] Treasury Department, Bureau of the Budget, General Accounting Office, press release, December 23, 1948.

ceipts or expenditures for different years to make sure that the figures are on the same basis. The items affected for the fiscal years 1941 to 1948 are shown in Table 1.

One new feature of the budget document for the fiscal year 1949 was a compilation of Federal grants to state and local governments.[10] The functional classification of expenditures and the budgets of government corporations were also improved.

Transfer of Surplus

One other budget technicality was the provision of the Economic Cooperation Act transferring $3 billion of the surplus of the fiscal year 1948 to the fiscal year 1949.[11] This gesture was proposed by Congressional supporters of tax reduction who wished to assure a nominal surplus in fiscal year 1949 and was also favored as a means of lessening opposition to the European Recovery Program.[12] It was, of course, merely a bookkeeping device, without economic significance. President Truman relegated the transfer to a footnote in his January, 1949, budget, setting forth the surplus for 1948 and the anticipated deficit for 1949 without regard to the transfer.

REVENUE ACT OF 1948

Major Provisions

The Revenue Act of 1948 (Public Law 471, 80th Congress, 2d session) made important changes in the individual income tax and in the estate and gift taxes. Income-tax provisions of the act include: (1) rate reductions bringing the first-bracket rate down from 19 per cent to 16.6 per cent and the top-bracket rate down from 86.45 per cent to 82.1 per cent; (2) income splitting for husbands and wives; (3) an increase in per capita exemptions from $500 to $600; (4) a special additional exemption of $600 for persons over 65 years of age; (5) a special additional exemption of $600 for the blind, substituted for a $500 deduction allowed under prior law; (6) an increase in the standard deduction. The estate and gift taxes were revised by: (1) repeal of the 1942 amendments, which had restricted the effect of the community-property laws on these taxes; (2) estate splitting, by allowance of a deduction of property passed outright to a decedent's spouse, up to a limit of 50 per cent of the gross estate; and (3) gift splitting, by allowance of an option for husbands and wives to treat gifts as made one-half each by the husband and wife.

The revenue loss from the act for a full year was estimated at $5 billion by the Treasury and at $4.8 billion by the staff of the Joint Committee on Internal Revenue Taxation.[13] The Treasury's estimates of the losses from each provision of the act are shown in Table 2.

Legislative History

The Revenue Act of 1948 grew out of a bill (H.R. 4790, 80th Congress, 1st

[10] *Budget for the Fiscal Year 1949*, pp. 1303-04.

[11] Economic Cooperation Act of 1948, sec. 114 (f).

[12] *New York Times*, February 18, 1948.

[13] The Joint Committee staff estimates were lower despite the fact that they were based on personal income of $208 billion, while the Treasury estimates assumed personal income of $200 billion. The Joint Committee staff estimated the reduction in individual income tax liabilities at $4.6 billion, in estate and gift tax liabilities at $0.2 billion. *Revenue Act of 1948*, Report of the Committee on Finance, Senate, 80th Cong., 2d sess., Report No. 1013, p. 6.

session) introduced on December 18, 1947, by Representative Harold Knutson, then chairman of the House Ways and Means Committee. The introduction of this bill marked the beginning of the third round in a Legislative-Executive battle on tax reduction that had continued through the greater part of 1947. The President had vetoed two tax-reduction bills during 1947, and the vetoes had been sustained by narrow margins.[14] From the outset, however, it was freely predicted that H.R. 4790 was a " veto-proof " bill.

TABLE 2
ESTIMATED REVENUE LOSSES FROM PROVISIONS OF REVENUE ACT OF 1948 [a]
(In millions of dollars)

Provision	Revenue Loss
Individual income tax provisions	
Increase in per capita exemptions ..	1,745
Additional exemptions for the aged and the blind	269
Income splitting	804
Increased standard deduction	94
Rate reductions	1,827
Subtotal	4,738
Estate and gift tax provisions	250
Total	4,988

Source: Treasury Department, release, April 14, 1948.

[a] Estimates for a full year of operation on the assumption of personal income of $200 billion. The effects of the separate provisions are estimated consecutively, each on the assumption that the provisions listed above it are already in effect. Figures are rounded and will not necessarily add to totals.

One reason for early optimism about the legislative prospects of H.R. 4790 was the fact that, unlike its predecessors, the bill included the popular provision allowing husbands and wives to split income for tax purposes. As a concession to residents of community-property states, who would lose their preferred status under the income tax, the bill called for repeal of certain amendments to the estate and gift taxes enacted in 1942 to limit the effect of the community-property system on these two taxes.

Before hearings could be begun on H.R. 4790, President Truman submitted a tax proposal of his own. In his message on the state of the union, January 7, 1948, he recommended a " cost-of-living tax credit " of $40 for each individual taxpayer and $40 additional for each dependent. He suggested that the estimated revenue loss of $3.2 billion be made up by increasing taxes on corporate profits but did not specify exactly what form these increases should take.[15] On January 14, 1948, Representative John D. Dingell introduced a bill to provide the $40 credit and to reimpose the wartime excess profits tax with liberalized exemptions and credits.[16]

The Ways and Means Committee held brief hearings on H.R. 4790 on January 16 and 19, 1948, with four Government officials the only witnesses. The bill was reported by the committee on January 27, 1948. The Democratic members submitted a minority report vigorously criticizing H.R. 4790 but

[14] The earlier bills were H.R. 1 (80th Cong., 1st sess.) and H.R. 3950 (80th Cong., 1st sess.). For a discussion of them, see my article, "Federal Tax Legislative Activities in 1947," *National Tax Journal*, 1 (March, 1948), 67-78.

[15] *Congressional Record*, 94 (January 7, 1948), 36.

[16] H.R. 4968 (80th Cong., 2d sess.). This bill coincided with the President's proposal as interpreted by Secretary of the Treasury John Snyder. *Reduction of Individual Income Taxes*, Hearings before the Committee on Ways and Means, House of Representatives, 80th Cong., 2d sess., on H.R. 4790, pp. 21-22.

did not endorse the President's proposals.[17]

The bill passed the House on February 2, 1948, by a vote of 297 to 120.[18] A substitute measure embodying a modified version of the President's proposals was defeated by a vote of 258 to 159.[19] The House bill was estimated to reduce tax liabilities by approximately $6.5 billion in a full year.[20]

In the Senate, the Finance Committee deferred public hearings until after adoption of the legislative budget. In seven days of hearings between March 1 and 10, 1948, the committee received testimony from a variety of witnesses.[21]

After making certain technical revisions and scaling down the rate reductions provided by the House, the Senate Finance Committee reported the bill on March 16, 1948.[22] During the Senate debate, the strongest opposition move was an amendment to restore the excess profits tax, which was defeated by a vote of 58 to 26.[23] The bill was passed by the Senate on March 22, by a vote of 78 to 11.[24] In the final stages of the debate, Senator Eugene Millikin, chairman of the Finance Committee, spoke of the bill as a "calculated risk" and promised to vote for higher taxes if it became necessary.[25]

The House immediately accepted the Senate bill intact and sent it to the President on March 24, 1948.[26]

On April 2, President Truman returned the bill with a veto message terming it an exhibition of "reckless disregard for the soundness of our economy and the finances of our Government." He objected that the bill would make a deficit likely, was inflationary, and was an inequitable tax revision.[27]

On the same day, both the House and the Senate overrode the veto by large margins. In the House, the vote was 311 to 88; in the Senate, 77 to 10.[28]

Economic Issues

The President and Administration spokesmen opposed tax reduction in 1948 on the grounds that it would

17 *Revenue Act of 1948*, Report of the Committee on Ways and Means, House of Representatives, 80th Cong., 2d sess., Report No. 1274 (January 27, 1948). It was reported that the committee rejected the President's plan by a vote of 19 to 5, with 4 Democrats joining the 15 Republicans in opposing it. *New York Times*, January 28, 1948.

18 *Congressional Record*, 94 (February 2, 1948), 926.

19 *Ibid.*, p. 925.

20 This is the Treasury estimate (*Reduction of Individual Income Tax*, Hearings before the Committee on Finance, Senate, 80th Congress, 2d sess., on H.R. 4790, p. 22). The staff of the Joint Committee on Internal Revenue Taxation, which assumed a somewhat higher income level, estimated the reduction at $6.7 billion (*Revenue Act of 1948*, Report of the Committee on Finance, Senate, 80th Cong., 2d sess., Report No. 1013 [March 16, 1948], p. 6).

21 Secretary of the Treasury Snyder did not appear in person but filed a statement.

22 *Revenue Act of 1948*, Report of the Committee on Finance, Senate, 80th Cong., 2d sess., Report No. 1013 (March 16, 1948). Part 2 of the report, dealing with the estate and gift taxes, was filed March 17, 1948. It was reported that the vote of the Finance Committee was 10 to 1 in favor of the bill, with 3 Democrats joining the 7 Republicans in favor of the bill, 2 Democrats absent, and 1 Democrat against the bill. *New York Times*, March 12, 1948.

23 *Congressional Record*, 94 (March 19, 1948), 3159.

24 *Congressional Record*, 94 (March 22, 1948), 3233.

25 *Ibid.*, p. 3222.

26 The vote was 289-67. *Congressional Record*, 94 (March 24, 1948), 3413.

27 *Congressional Record*, 94 (April 2, 1948), 4051-3.

28 *Ibid.*, pp. 4053, 4026.

aggravate the inflation problem. Congressional supporters of the Revenue Act of 1948 viewed tax reduction as essential to preserve economic incentives, to provide business capital funds, and to improve the form of business financing.

Inflationary Pressures.—In reply to the Administration's arguments, the Congressional committees did not deny that inflation might continue in 1948. The Senate Finance Committee asserted that under those conditions its bill would leave a large surplus which, if properly handled, would be a potent weapon against inflation. To combat inflation, it counselled the Treasury to use the available surplus to retire securities held by the Federal Reserve System, correctly pointing out that this would be more deflationary than retirement of securities held by the commercial banks or individuals. Perhaps, however, the committee exaggerated the Treasury's freedom of action in view of the policy of pegged interest rates, and the committee did not suggest that steps be taken to remove these limitations on Treasury action.

Moreover, the Senate Finance Committee contended that, by stimulating production, tax reduction would help restore the balance between total demand and supply. This method of attacking inflation it considered superior to a reduction in demand. In pressing this argument the committee neglected to mention that an increase in production would be accompanied by an equivalent increase in money incomes. Nor did it note that additional investment may be highly inflationary during the period between its initiation and the appearance of finished goods. Moreover, no recognition was given to the fact that because productive resources were already rather fully employed and because bottlenecks existed in particular areas, such as steel, additional investment outlays might result mainly in price rises rather than more physical facilities.

Turning to the possibility of a recession, the Senate Finance Committee unhesitatingly endorsed one-half of the doctrine of "functional finance." The committee said, "If ... the problem of the immediate future turns out to be not inflation but the avoidance of deflation, immediate tax reduction becomes imperative. ..."[29] Under deflationary conditions, incentives to work and invest continue to play a stellar role, but "the additional purchasing power generated by the increase in exemptions" now moves to the front of the stage to share the spotlight.

The Senate Finance Committee thus tried to show that tax reduction would fit either inflationary or deflationary conditions. Some critics might say that the committee was trying to enjoy the best of two worlds without facing the unpleasant realities of either. Others would merely observe that it resolved all doubtful questions in favor of its bill.[30]

Even at the end of the year it was impossible to say with assurance who was right and who was wrong in early

[29] Senate Finance Committee report, *op. cit.*, p. 12.

[30] If this were a detailed discussion of the President's tax program, it would be necessary to emphasize that the Administration glossed over the inflationary effects of its proposed cost-of-living tax reduction, gave little analysis of the relative anti-inflationary effects of individual income taxes and corporation taxes, and admitted (under questioning) that its program would reduce tax *collections*—but not liabilities—in the fiscal year 1949 by $2.4 billion. On this last point, see House Ways and Means Committee hearings, *op. cit.*, pp. 73-74.

1948. Turning points in business cycles usually can be identified only in retrospect. And no one knows what would have happened in 1948 if taxes had not been reduced.

Incentives.—It is unfortunately impossible to measure the effect of taxation on incentives to work and invest. In support of the Administration's position, it may be argued that there was little cause for concern in view of the peacetime record of national production in both 1947 and 1948 and the very high level of business investment. On the other hand, it must be conceded that, whatever general economic conditions prevail, there is always a presumption that a tax reduction will stimulate some additional work and investment. It will also stimulate additional consumer spending. In appraising the desirability of tax reduction at any particular time, it is necessary to take into account the effects of additional spending for both consumer goods and investment goods as well as the incentive effects. When production, consumption, and investment are already running at high levels, as they were in 1948, there is a real danger that any beneficial effects that tax reduction may have on incentives will be more than offset by further inflation. Even if the net result is an immediate or ultimate increase in production—which is not certain in view of the disorganizing effect of inflation—the social cost of the inflation may exceed the social benefits of the additional output.

Business Financing.—Another argument advanced in favor of tax reduction was that it would increase the amount of venture capital available and would improve the character of business financing. The Senate Finance Committee held that while there might be no over-all shortage of savings there was a shortage of risk capital. The committee pointed out that undistributed corporate profits represented an unusually large proportion of total investment funds in 1947 and that an unusually large proportion of new securities were of the fixed-income type rather than stock.[31]

The views of the Senate Finance Committee were shared by members of the financial community who testified, but the Secretary of Commerce saw no definite evidence of a serious shortage of risk capital. It is inevitable that many ventures will always be unable to obtain enough capital. There is no generally accepted rule for deciding whether too many potential investments are thus being prevented. One relevant fact, however, is that investment in nonfarm plant and equipment was 8.7 per cent of the gross national product in 1947, a fraction that had been exceeded only in 1929 during the period 1919 to 1947.[32]

Many would agree that heavy reliance on retained profits as a means of financing is unwholesome. Investment financed by retained profits is not subject to the test of the capital market, and the result may be a poor allocation of resources. This means of financing helps to entrench established profitable firms as compared with new firms. Furthermore, it is plausible to assume that the heavy reliance on internal financing was partly due to high rates of individual income tax. Also important, however, were the high level

[31] Senate Finance Committee report, *op. cit.*, p. 15.

[32] Department of Commerce estimates, Senate Finance Committee hearings, *op. cit.*, p. 437.

of corporate profits and the increase in replacement costs of capital assets, which gave corporations both an opportunity and a special inducement to retain large sums.

In 1947, approximately 24 per cent of total new long-term domestic corporate securities were stock and approximately 76 per cent were bonds and notes. In 1946, the figures were 31 per cent and 69 per cent. Stock was relatively less important in both 1946 and 1947 than it had been in the late 1920's but more important than in most years since 1930.[33] Regardless of whether the 1946-47 situation could properly be considered unusual, the Senate Finance Committee was justified in its contention that the present tax system puts a premium on debt financing as compared with equity financing. The direct attack on this problem, however, would be a change in the corporation income tax rather than the individual income tax. Moreover, nontax factors, such as the growing importance of insurance companies as purchasers of corporate securities and low interest rates, also favor fixed-income securities. Certainly the reduction of individual income tax was not immediately effective in stimulating equity financing. In 1948, stock made up only 15 per cent of new long-term issues.[34]

[33] For the period 1921-30 inclusive, the median figure for stock was 28 per cent of total long-term issues; for 1931-45 inclusive, 12 per cent. *Commercial and Financial Chronicle* series: 1946-47, *Commercial and Financial Chronicle*, 169 (January 31, 1949), 489; 1941-45, *ibid.*, 163 (January 28, 1946), 507; prior years, *Statistical Abstract of the United States*, annual volumes.

[34] *Commercial and Financial Chronicle*, 169 (January 31, 1949), 489.

Equity Considerations

Table 3 compares effective rates of individual income tax under the Revenue Act of 1948 and prior law for a married person with two dependents. In the table it is assumed that the husband receives all of the income and the family resides in a noncommunity-property state.

Supporters of the act emphasized that the percentage reduction in tax liability was greatest for low-income taxpayers. Opponents of the act called attention to the fact that the percentage increase in income remaining after tax —" take-home pay "—was greatest for high-income taxpayers. From either point of view, the reduction in tax rates was less significant for most taxpayers than other features of the act. For low incomes, the increase in exemptions overshadowed the rate reductions. For high incomes—especially in the range $15,000 to $100,000—income splitting, where applicable, was much more important than the rate reductions.

The Treasury Department estimated that 63 per cent of the total reduction in income tax liabilities went to taxpayers with net incomes below $5,000 and 37 per cent to those with incomes above $5,000. The reduction amounted to about one-fourth of the estimated total liability under prior law for the first group and to about one-sixth for the second group. Almost one-half of the total reduction for the whole group with incomes above $5,000 was attributable to income splitting.[35]

The income-splitting provision of the 1948 act unquestionably increased the equity of the tax system by decreasing unjustifiable differences in income tax

[35] Treasury Department release, April 14, 1948.

TABLE 3

COMPARISON OF EFFECTIVE RATES OF INDIVIDUAL INCOME TAX UNDER REVENUE ACTS OF 1945 AND 1948, MARRIED PERSON, TWO DEPENDENTS [a]

Net Income	Effective Rates		Decrease in Effective Rates	Decrease as Percentage of:	
	1945 Act	1948 Act		Tax under 1945 Act	Income after Tax under 1945 Act
$ 2,400	3.2%	0	3.2%	100.0%	3.3%
3,000	6.3	3.3%	3.0	47.6	3.2
4,000	9.5	6.6	2.9	30.1	3.2
5,000	11.8	8.6	3.1	26.7	3.6
6,000	13.3	10.0	3.3	25.1	3.9
8,000	16.2	12.2	4.0	24.6	4.7
10,000	18.6	13.6	5.0	26.9	6.2
15,000	24.3	16.7	7.5	31.0	9.9
20,000	29.5	19.4	10.0	34.0	14.2
25,000	34.1	21.9	12.2	35.7	18.5
50,000	48.2	33.2	15.1	31.2	29.1
100,000	62.3	45.6	16.7	26.7	44.2
250,000	76.2	62.3	13.9	18.2	58.4
500,000	81.3	71.7	9.6	11.8	51.3
1,000,000	83.9	76.9	7.0	8.3	43.1

Source: Treasury Department release, April 14, 1948.

[a] Noncommunity-property state; one spouse assumed to have all of the income.

liabilities of persons with equal incomes but different places of residence or different types of incomes. Residents of community-property states had long enjoyed a tax advantage by virtue of the equal division of community income between husband and wife. In the common-law states, investors were often able to divide income among family members by gifts of income-producing property. Under a progressive rate structure, division of income can result in large tax savings. With high tax rates the advantages of the community-property system became increasingly attractive, and several states changed to that system while others threatened to do so. The 1948 act eliminated the previous discriminations between married couples with equal combined incomes by universalizing the privilege of income splitting.

The idea of general income splitting had been widely endorsed since it was outlined in 1946 by the Tax Legislative Counsel of the Treasury Department.[36] Previous recommendations of the Treasury Department for ending existing discriminations by compulsory joint returns of husbands and wives or by taxing income to the spouse exercising management and control over it had not be accepted by the Congress.[37]

Although income splitting eliminates certain types of inequity, it is by no means clear that it results in a more equitable relation between the tax of married and single persons and between that of high- and low-income groups. The new arrangement results in higher taxes on single persons relative to married persons and on low incomes rela-

[36] Stanley S. Surrey, "Family Income and Federal Taxation," *Proceedings of the National Tax Association*, 1946, pp. 357-69; reprinted in *Taxes*, XXIV (October, 1946), 980-7.

[37] The Treasury recommended one or the other of these proposals in 1924, 1933, 1934, 1937, 1941, and 1942. See Treasury Department, Division of Tax Research, *The Tax Treatment of Family Income* (Washington, 1947), pp. 7-9.

tive to high. It is not obvious that the per capita basis of graduation is preferable to the family basis. In the lower- and middle-income groups the cost of providing an equivalent standard of living appears to be greater for a married couple than for a single individual but considerably less than twice as great, perhaps partly because the value of the services of the wife are typically not considered income.[38] In the higher brackets, the social significance of income concentration must surely be measured on a family basis. If income splitting between husbands and wives is equitable, the question may be raised why the splitting should not be extended to include children and other dependents. But if these doubts are well founded, one can only conclude that compulsory joint returns would have been the equitable approach—not that the old law was better than the new. And experience offered no hope that compulsory joint returns could be adopted.

The special exemptions for taxpayers over 65 and for the blind are a dangerous precedent for the extension of favors to other groups. Moreover, tax exemption is an inefficient means of helping needy groups. The exemption, of course, is of no value to those with the lowest incomes who presumably are in greatest need, and for those with higher incomes it increases in value with the size of the taxpayer's income.

The general increase in exemptions, which was defended mainly as relief from the high cost of living, raises a difficult problem. Rising prices had reduced the real value of the exemptions far below what it was when the $500 per capita system was adopted during the war. One must sympathize with the view that relief was needed. On the other hand, the tax reduction resulting from increased exemptions—estimated to account for almost two-fifths of the total income tax cut—was certainly an additional inflationary force.

The estate- and gift-splitting provisions of the 1948 act are highly technical and cannot be discussed in detail here.[39] It seems fair to say, however, that, despite their superficial resemblance to income splitting, these provisions stand on an altogether different footing. Although no one seriously defended the existing income tax situation, the Treasury argued that the 1942 amendments had already achieved substantial equality of estate and gift taxes in community-property and other states.[40] Competent students believe that the 1948 act will not achieve geographical uniformity in estate and gift taxes and foresee grave difficulties under the new law.[41] It must be recorded, however, that the tax section of the American Bar Association strongly supported the 1948 revisions.[42]

The point to be stressed here is that, with very little Congressional debate

[38] Treasury Department, Division of Tax Research, *Individual Income Tax Exemptions* (Washington, 1947), pp. 5-8.

[39] For detailed treatments, see Stanley S. Surrey, "Federal Taxation of the Family—The Revenue Act of 1948," *Harvard Law Review*, LXI (July, 1948), 1097-1164; Willard H. Pedrick, "The Revenue Act of 1948: Income, Estate and Gift Taxes—Divided They Fall," *Illinois Law Review*, XLIII (August, 1948), 277-322.

[40] Senate Finance Committee hearings, *op. cit.*, p. 24.

[41] Surrey, *op. cit.*, pp. 1154-59; Pedrick, *op. cit.*, pp. 320-22.

[42] Senate Finance Committee hearings, *op. cit.*, pp. 300-64.

and almost no general public discussion, so-called technical amendments were adopted which are estimated to reduce the yield of the estate and gift taxes by 30 per cent or more.[43] For certain big estates and certain types of dispositions of property, the cuts will greatly exceed the average. At the same time, the administrative advantages of the estate tax—which, unlike the inheritance tax, formerly was not affected by the disposition of the property—have been largely sacrificed.[44] The events of 1948 illustrate again a serious weakness of our tax legislative process—the apparent impossibility of sharply separating technical questions from fundamental questions.

TAX REVISION BILL

Beginning in May, 1947, the House Ways and Means Committee held extensive hearings on general tax revisions.[45] The committee appointed a special tax study committee under the chairmanship of Roswell Magill, which reported to the Ways and Means Committee in November, 1947.[46] The Treasury Department also submitted a number of tax studies to the Congressional committees.

In May, 1948, the Ways and Means Committee reported to the House a technical tax revision bill (H.R. 6712, 80th Congress, 2d session). The bill was intended, in the words of the committee, to "remove inequities, . . . prevent tax avoidance, simplify the tax system, moderate certain harsh provisions and provide increased incentives to management and venture capital." It contained eighty sections dealing with income, estate, and gift taxes and with certain administrative matters. Although the bill was said to be restricted to revisions that would have little effect on the revenue, the committee estimated that the total reduction in tax liabilities would be on the order of $400 million.[47]

H.R. 6712 was passed by the House,[48] but it was not acted upon by the Senate.

The bill was intended to be the first general technical tax revision since 1942. The numerous provisions of the bill differed considerably in significance and the extent to which they were controversial. Many of the revisions had been recommended by the Treasury.[49] Others were suggested by the special tax study committee or by taxpayers. Most of the proposed changes appear to have been intended to grant relief to taxpayers rather than to plug loopholes or improve administration. Only a few of the more interesting and important provisions can be mentioned here.

Loss Carry-over.—One of the more important provisions of the bill was the proposed modification of the net oper-

[43] Treasury Department release, April 14, 1948.

[44] Surrey, *op. cit.*, pp. 1127, 1158, 1163.

[45] *Revenue Revisions, 1947-48*, Hearings before the Committee on Ways and Means, House of Representatives, 80th Cong., 1st and 2d sess. (1947-48).

[46] *Reports of the Special Tax Study Committee* to the Committee on Ways and Means, House of Representatives, 80th Cong., 1st sess. (November 4, 1947).

[47] *Revenue Revision Act of 1948*, Report of the Committee on Ways and Means, House of Representatives, 80th Cong., 2d sess., Report No. 2087 (May 28, 1948), pp. 1-2. A large part of the revenue reduction was attributable to a provision continuing the exemptions and exclusions for military pay.

[48] *Congressional Record*, 94 (June 19, 1948, daily edition), 9322.

[49] Letter of Under Secretary of the Treasury A. L. M. Wiggins to Representative Harold Knutson, February 26, 1948 (Treasury Department release).

ating loss carry-over (sec. 136). The bill would have substituted a one-year carry-back and a five-year carry-forward for the existing two-year carry-back and two-year carry-forward. Emphasis was placed on carry-forwards rather than carry-backs because the former were considered more beneficial for incentives, more advantageous to new businesses, and easier to administer. Both the extension of the loss-offset period and the emphasis on carry-forwards have come to be rather generally approved on equity and economic grounds.

The bill would also have liberalized the method of computing net operating loss for carry-over purposes. Taxpayers would no longer have been required to reduce statutory loss by the amount of tax-exempt interest received, the excess of percentage depletion over cost depletion, and the 50 per cent of long-term capital gains excluded from income. The intent of the present law is to grant a loss carry-over sufficient only to prevent the tax from encroaching on capital. But, as the Ways and Means Committee pointed out, the present law discriminates against certain taxpayers with fluctuating incomes in the sense that they derive less tax benefit from the tax-exempt interest, percentage depletion, and capital-gains treatment than do taxpayers with stable incomes.

Improper Accumulation of Surplus.—Section 102 of the Internal Revenue Code now imposes a special surtax on corporations retaining earnings for the purpose of preventing imposition of the surtax on individual stockholders. Accumulation of earnings beyond the reasonable needs of the business is determinative of the purpose of avoiding surtax unless the corporation can prove the contrary "by a clear preponderance of the evidence." This latter provision, shifting the burden of proof to the taxpayer, was adopted in 1938 because the Treasury found it extremely difficult to prove that a corporation was actually used to avoid surtax on its shareholders.[50] Even in its strengthened form the special surtax has been successfully applied in only a relatively few cases.[51] Nevertheless, complaints are heard that fear of application of the tax induces many corporations to distribute an excessive portion of their profits.

The Ways and Means Committee proposed to shift back to the Treasury the burden of proving accumulations to be in excess of business needs, provided taxpayers complied with the formal requirement of filing statement of their business needs for the retained funds. Although the committee bill went somewhat less far than some taxpayers have urged, there seems little doubt that its enactment would have drawn most of the few teeth that section 102 now has.

Family Partnerships.—In 1946 the Supreme Court refused to recognize

50 This was merely the last of several steps in strengthening this provision. For example, until 1918 it was necessary for the Commissioner of Internal Revenue to prove, before taking action, that a corporation had been "fraudulently" used to avoid individual surtaxes. On the legislative history of the section, see H. J. Rudick, "Section 102 and Personal Holding Company Provisions of the Internal Revenue Code," *Yale Law Journal*, XLIX (1939), 171-223; William L. Cary, "Accumulations Beyond the Reasonable Needs of the Business: the Dilemma of Section 102(c)," *Harvard Law Review*, LX (1947), 1282-1313.

51 Cary, *op. cit.* On Treasury policy with respect to sec. 102, see a statement of Commissioner of Internal Revenue George J. Schoeneman, December 5, 1947 (Treasury Department Press Service No. S-554).

family partnerships for tax purposes in cases where the partners contributed no capital originating with themselves or performed no important services.[52] Thus taxpayers were prevented from splitting their income among family members by the easy device of making a gift of partnership interest.

H.R. 6712 would have recognized family partnerships if each partner contributed capital or services in reasonable proportion to his share of profits. And the capital could have originated in a gift from another member of the family. Each partner would have had to be at least 21 years old, and certain accounting and other requirements would have had to be met.

With the adoption of income splitting between husbands and wives in the Revenue Act of 1948, the attractiveness of the family-partnership device was substantially decreased. For the future, therefore, the bill would have been significant mainly in those cases where a taxpayer wished to extend the advantages of income splitting to members of his family other than his wife. But the committee bill granted retroactive relief to the year 1941. Thus the committee came to the aid of those who had guessed wrong about a means of avoiding high taxes on wartime profits.

Employee Stock Options. — Under present law, an employee exercising an option to buy stock in the corporation employing him realizes ordinary income at that time equal to the difference between the option price and the fair market value of the stock. It has been complained that the fact that the employee must pay a tax at a time when he receives no additional cash income defeats the purpose of stock-option plans, which are supposedly intended to give executives an increased interest in the success of the employing corporation. The employee must either draw on other resources to pay the tax or must sell part of his shares.

H.R. 6712 (sec. 137) would have established the following rules for employee stock options: (1) the employee would not have been liable for tax until he sold the stock; (2) if he sold the stock three years or more after exercise of the option, the difference between the option price and the selling price would have been taxed as a long-term capital gain; (3) if he sold the stock in less than three years, the difference between the option price and the fair market value at the date of exercise of the option would have been treated as ordinary income, and any difference between the fair market value at the date of exercise of the option and the selling price would have been treated as a capital gain. The foregoing rules would have applied only in cases where the option price was not more than 10 per cent below the fair market value when the option was granted, and certain other requirements were met. If the option price were more than 10 per cent below the market value when the option was granted, the difference between the option price and market price would have been taxed as ordinary income at the date of exercise of the option. In the former case, the corporation would have received no deduction, but in the latter case it would have received a deduction equal to the amount taxed as ordinary income to the employee.

[52] *Commissioner* v. *Tower*, 327 U.S. 280 (1946); *Lusthaus* v. *Commissioner*, 327 U.S. 293 (1946).

In supporting its plan, the Ways and Means Committee stressed the desirability of stock options as an incentive to business executives to interest themselves in the success of the corporation. It stated that options qualifying for preferred treatment were regarded as "incentive rather than compensatory devices." In view of the fact that the options confer financial benefits and are given only to employees in recognition of past services or in anticipation of future services, it is extremely hard to draw any fundamental distinction between the gain from exercising the option and compensation in the form of salaries and bonuses.[53] Throughout the whole economy salaries and bonuses are much more important incentives to executives than are option plans, and taxation of salaries and bonuses probably does more to prevent executives from buying stock than does taxation of gain from exercise of stock options. There seems to be no obvious reason for favoring one kind of incentive plan as compared with the other. Even if it be granted that option plans are a specially desirable incentive device, it would seem that the greatest concession that could be justified would be postponement of payment of the tax on the gain until the stock was sold. The Treasury was willing to recommend such postponement, but the Ways and Means Committee proposed to grant not only postponement but the low capital-gains tax rate.

Gifts in Contemplation of Death.—Under present law gifts in contemplation of death are included in the estate of the donor, and the statute establishes a rebuttable presumption that all gifts made within two years prior to death are in contemplation of death. Noting the extreme difficulty of proving that a gift was actually made in contemplation of death, the Ways and Means Committee proposed that the presumption period be extended to three years and that the contemplation-of-death clause be made inapplicable to gifts made more than three years prior to death. Undoubtedly, the proposed modification would reduce litigation, and extension of the presumption period might even increase the revenues. But it is easy to imagine situations in which a three-year cutoff date would permit gifts which would now be included in the estate to escape the estate tax.

Other Provisions.—Other provisions of H.R. 6712 included: (1) a new rule for tax-free recovery of the cost of annuities, which would have apportioned the cost over the life expectancy of the annuitant; (2) elimination of the "premium-payment" test for inclusion of life insurance in taxable estates; (3) inclusion in a taxable estate of only the actuarial value of the decedent's reversionary interest in property previously transferred; (4) liberalized treatment of gains and losses in connection with certain corporate liquidations and reorganizations; (5) overruling of the principle of the *Dobson* case (320 U.S. 489 [1943] limiting the scope of judicial review of Tax Court decisions;[54] (6) percentage depletion for marble and granite. Many other technical provisions were embodied in the bill.

[53] Martin Atlas, "Toward a Concept of Compensation," *Tax Law Review*, II (1946-47), 85-94.

[54] This provision has been separately enacted into law (Public Law 773, 80th Cong., 2d sess., approved June 25, 1948).

MISCELLANEOUS REVENUE LEGISLATION

Social Security

Two acts of Congress, passed over the President's veto during 1948, narrowed the coverage of the social security system and hence of the payroll taxes. One of these acts excluded services performed in the sale of newspapers and magazines where the salesman is compensated by a purchase and sales agreement, regardless of the existence of a minimum guarantee or the privilege of returning unsold items at cost.[55] The second act continued the common-law rules for determining whether a person is an "employee" within the meaning of the Social Security Act, thereby excluding from coverage salesmen, piece workers, truck drivers, and others.[56]

Oleomargarine Taxes

On April 26, 1948, the House discharged its Committee on Agriculture from further consideration of a bill[57] repealing the various Federal excise and license taxes on manufacure and sale of oleomargarine. After a bitter debate in which sectional and economic interests combined to break down the majority's unity, the bill was passed by the House on April 28.[58] In the Senate the bill was referred to the Finance Committee, rather than the Agriculture Committee, and was reported favorably June 1, 1948.[59] However, it was not acted upon by the Senate.

FEDERAL DEBT OPERATIONS

During 1948 Federal debt operations were heavily influenced by the policy of maintaining continued low interest rates. This policy required large-scale support activities by the Federal Reserve Banks. In December, 1947, a support pattern had been esablished that provided a rate of 2½ per cent on long-term Government bonds and 1⅛ per cent on one-year certificates. This pattern was continued until August, 1948, when the rate on one-year certificates was allowed to rise to 1¼ per cent. During 1948 the Treasury used a large part of the surplus to retire securities held by the Federal Reserve Banks. This policy caused commercial banks to lose reserves, which they replaced by sale of Government securities to the Federal Reserve Banks. Other financial institutions also sold Governments to the Federal Reserve Banks in order to secure funds to expand loans and other investments. The net effect was a substantial decline in holdings of commercial banks and insurance companies and a small net increase in holdings of the Federal Reserve Banks.[60]

CONCLUSION

The fiscal history of 1948 may prove to be an important chapter in the development of the postwar tax system. Under pressure for tax reduction, plans

[55] Public Law 492, 80th Cong., 2d sess., effective April 20, 1948.

[56] Public Law 642, 80th Cong., 2d sess., effective June 14, 1948. This act was estimated to exclude up to 750,000 persons from coverage. (See veto message, *Congressional Record*, 94 [June 14, 1948], 8188.)

[57] H.R. 2245, 80th Cong., 2d sess.

[58] *Congressional Record*, 94 (April 28, 1948), 5008. During the debate, Southern supporters of the bill were threatened with reprisals against cotton and with removal of the protective duties on imported oils.

[59] Senate Report No. 1437; *Congressional Record*, 94 (June 1, 1948), 6748.

[60] For a review of the period through October, 1948, see "Credit Development and the Government Securities Market," *Federal Reserve Bulletin*, December, 1948, pp. 1455-63.

for fundamental tax revisions that had been discussed for several years were pushed aside. It seems to be commonly agreed that revisions that cost revenue —and most of those that have been widely discussed would—can be successfully made only at a time when total revenues are reduced. If this is so, the Revenue Act of 1948 has considerably narrowed the probable scope of legislation on matters such as integration of corporate and individual income taxes and reduction of excise taxes. The problem for the future, of course, is not to prevent further action but rather to try to make sure that as many alternatives as possible are clearly presented to the Congress and the public.

Both the Revenue Act of 1948 and the Tax Revision Bill illustrate the fact that so-called technical revisions may have far-reaching consequences for the distribution of the tax load. The unavoidable complexity of a tax system that attempts to do equity and prevent avoidance makes it difficult for the public and most members of Congress to understand the technical matters. Consequently, decisions significantly affecting the progressivity, yield, and economic impact of the tax system may be made indirectly and without adequate discussion.

The experiences of 1948 are further evidence that the theories of compensatory fiscal policy have outrun both the popular understanding of them and the development of methods for putting them into operation. The history of the year offers some support for the view that current public opinion, existing institutions, and the normal rules of politics all combine to give government policy a significant inflationary bias at the present time.

The arguments about tax reduction and tax revision heard in 1948 have not passed completely into history. Many of them will doubtless be heard again in 1949 in connection with the President's recommendation for a restoration of a major part of the 1948 tax reduction and in future years when tax legislation is under consideration.

INCOME TAX DEDUCTIBILITY: A REPLY

BYRON L. JOHNSON *

IN THE September, 1948, issue of this *Journal,* Mr. Herbert E. Klarman examines the effects of unilateral (Federal) and reciprocal deductibility on state and Federal income taxes.[1] He clearly proves that the additional burden of a state income tax is lightened by the existence of Federal deductibility and nearly vanishes, especially in the upper brackets, under reciprocal deductibility. He further proves that the combination of Federal and state rates will never be confiscatory so long as neither rate alone is confiscatory and deductibility is offered taxpayers, if only by the Federal Government. It is well to have these facts so clearly established.

Mr. Klarman, however, is not content to stop at that point. He goes on to establish that "the deductibility feature causes the Federal Government to share the income tax liability of a taxpayer in an income-tax state." (p. 245) Some states derive a differential advantage from Federal deductibility by refusing to allow state income taxpayers a deduction for Federal income taxes paid, or by limiting the allowable deduction. Mr. Klarman therefore believes that "a comprehensive plan for coordination might do well to ask for reciprocal deductibility, in order to eliminate the revenue advantages non-deductibility states now enjoy over states granting deductibility." (p. 248)

This position is open to several attacks:

1. Mr. Klarman has established that reciprocal deductibility requires, for an equitable solution, that the taxpayer solve simultaneous equations or use elaborate tables requiring joint Federal-state approval—hardly in keeping with the principle of simplicity or understandability. There will be no such problem under unilateral deductibility.

2. Mr. Klarman calls the present Federal deductibility provision a "subsidy to state income taxes," but are not the Federal deductibility clauses also subsidies to retail sales taxes, to property taxes, to charitable and religious institutions, to home ownership, and to a host of other no more worthy causes? So long as the provision is a broad as it is now, it is hardly fair to single out its effect on state and local income taxes for special treatment. If any change is to be made, it might better take the direction of withdrawing the "subsidy" from property, sales, and other state and local taxes not geared to ability to pay, as William Vickrey suggests.[2]

Disdain for the progressivity of state and local tax structures has all too often led to state adoption of taxes that are regressive at low income levels not reached by the Federal income tax.

3. The differential revenue advantages afforded some states would be wiped out if all states eliminated deductibility of Federal income taxes.

4. State and local tax structures are not as flexible as the Federal tax system. Biennial sessions of state legislatures and the long lags in local property tax procedures make this condition hard to overcome. Unilateral (Federal) deductibility offers more protection to state revenues against unpredictable changes in the Federal in-

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1 "Income Tax Deductibility," *National Tax Journal,* I (September, 1948), 241-249.

2 William Vickrey, *Agenda for Progressive Taxation* (New York: Ronald Press, 1947), pp. 397, 95-100, and 310-312.

come tax than does reciprocal deductibility.

5. From the state's point of view, state deductibility is a "subsidy" to the Federal income tax. There is plenty of reason, in these times, for Federal deductibility, if only to avoid confiscation. But there is no such compelling reason for state (or local) subsidies to the Federal Government.

In light of these considerations, the states having income taxes might be better advised to follow the lead of the states which have already abandoned deductibility of the Federal income tax. A coordination plan might well endorse such a change. It is obvious that the effect on state revenues of allowing deductibility of Federal income taxes is far greater, proportionately, than the effect on Federal revenues of allowing deductibility of state income taxes paid, especially when the Federal deductibility is also extended to the alternative taxes the state must levy to make up the revenue lost through *allowing* deduction of Federal income taxes.

INCOME TAX DEDUCTIBILITY: A REJOINDER

HERBERT E. KLARMAN *

PROFESSOR JOHNSON'S position, as I understand it, is that he favors unilateral deductibility by the Federal Government but opposes reciprocal deductibility by the states. Both types of deductibility serve to reduce interstate tax differentials and to prevent confiscatory tax burdens. It is Professor Johnson's belief that unilateral deductibility accomplishes these twin objectitives adequately. Considering these objectives alone, there is, in his opinion, little gain in securing a grant of deductibility from the states too. Indeed, Professor Johnson believes that, if other relevant considerations are taken into account, reciprocal deductibility results, on balance, in a net loss. Professor Johnson argues that reciprocal deductibility is open to attack on these grounds: (1) It violates the principle of simplicity. (2) It impairs the progressivity of the state income tax. (3) It is not the only available means for eliminating the differential revenue advantages accruing to some states. (4) It exposes the revenues of the states to the vagaries of the Federal income tax. (5) It results in a subsidy to the Federal Government from the states.

In the interest of clarity, Professor Johnson's criticism is examined point by point:

1. It is agreed that the principle of simplicity should be observed to the utmost. The original paper states that "... computations under reciprocal deductibility require the use of different tables of tax deductibility in the several states..." (p. 247). Footnote 13 adds that "The tables would be derived from... formulas." The solution of these formulas is of no concern to the taxpayer, who consults only the end product, the tables. Reading of tables by the taxpayer is practised and accepted under the existing Federal income tax.

2. Although it is agreed that reciprocal deductibility impairs the progressivity of the state income tax, the meaningfulness of this separate view of the state rate structure remains doubtful. As Professor Johnson correctly indicates, allowance of any deduction under a progressive rate structure necessarily diminishes the rate of progression of the tax. The propriety of any given deduction must, therefore, be assessed in terms of compatibility with acknowledged objec-

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tives of public policy, with the effect on the progressivity of one of the taxes viewed as somewhat incidental. The writer believes that minimization of differentials in total income tax liability between residents of the various states is desirable; and it cannot be denied that in this respect, reciprocal deductibility is more effective than unilateral deductibility.

3. It is agreed that reciprocal deductibility is not the only means of eliminating revenue advantages now accruing to some of the states. The differential revenue advantages enjoyed by some states would be as readily wiped out by having all states eliminate deductibility of the Federal income tax. Other objectives would not be so well served, however. (See 2 above.)

4. Undeniably, reciprocal deductibility does expose state income tax revenue to changes in Federal policy. Still, it does not follow that the states must stand by helpless, unable to take remedial action. The legislation passed by the State of Wisconsin in 1941, cited in note 12, page 246, is a good example of quick, preventive action, although perhaps not of the most desirable type.

5. From the standpoint of intergovernmental relations, it seems not unreasonable to view the end product of reciprocal deductibility as a diminution of the Federal subsidy to the state income taxes, rather than as a subsidy from the states to the Federal Government. But this is largely a difference in phrasing and there is little point in dwelling on it.

In summary then, the writer agrees with Professor Johnson that some form of deductibility is desirable. He concedes that unilateral deductibility is superior to no deductibility at all. However, he does believe that reciprocal deductibility is the more effective instrument as well as the more equitable with respect to the several states. The technical difficulties entailed in using it can be overcome, and so can its apparent regressive effect on the state income tax, should that be desired. Therefore, employment of reciprocal deductibility as a means of furthering a comprehensive program of intergovernmental fiscal coordination, which would aim to promote procedural uniformity but permit substantive diversity, seems reasonable.

BOOK REVIEWS

British Block Grants and Central-Local Finance. By REYNOLD E. CARLSON. (The John Hopkins University Studies in Historical and Political Science, Series LXV, No. 1.) Baltimore: Johns Hopkins University Press, 1947. Pp. xiv + 222. $2.50 (paper).

This is a study of the operation of the block grant system established by the Local Government Act of 1929. This act provided for the "derating" of agricultural and industrial property in a way analogous to the classified property tax in some of the American states. The block grant was intended to serve the double purpose of compensating the local authorities for loss of revenue resources, and also to distribute aid from the national treasury so as to equalize the burden of local government. The grant was distributed according to a complex formula in which population was weighted principally by the number of young children and the extent of unemployment.

Dr. Carlson's study shows how the purposes of this plan were frustrated by the depression and later the war. The child population was shifted, unemployment became a charge against the national budget, while the new services undertaken during the war had to be financed by a series of special grants. Various make-shift arrangements were adopted as the result of a species of collective bargaining between associations of the local authorities and the ministries at Whitehall. This study emphasizes, as have several others, that the block grant failed in the attempt to equalize local fiscal burdens. The poorer areas still had to raise heavier rates to maintain inferior public services. At the same time one of the great advantages of the grant-in-aid system, as was pointed out long ago by Sidney Webb, was lost. The grants became unconditional for general local purposes, and national direction of local activities was secured by the issuance of directives and instructions to the local authorities.

Unfortunately, the monograph here reviewed stops with the situation in 1947, so today it is largely of historical interest. Toward the end of 1947 Parliament passed a new Local Government Act which abolished the block grant system entirely. It substituted "Exchequer Equalisation Grants" which distribute the aid to those local governments which are unable to meet costs by the levy of a uniform rate. As in the United States, one of the great problems in applying equalization formulae is the great inequality of assessments. The British act of 1947 substitutes valuation by national civil servants of the Inland Revenue for the local assessing authorities with, however, appeals to local boards and the courts. In addition to the Local Government Act, further changes in the British grant-in-aid system will be necessitated by projects now under discussion for reorganization of educational, health, and highway services.

The British experience with the block grant may be of interest to students of American public finance mainly as an unsuccessful experiment. The block grant is essentially similar to shared taxes in the American states, though not limited to the proceeds of particular revenues. It is not successful as an equalizing device. Account must be taken of the particular service to be financed at some uniform minimum standard, and there must be adequate control of valuation as a necessary condition to effective equalization of the burden of maintaining local services. The present British experiments should be watched with interest by students of public finance here.

HENRY J. BITTERMANN

Washington, D.C.

Federal Excise Taxes on Alcoholic Beverages. U. S. Treasury Department, Division of Tax Research. Washington, June, 1948. Pp. 101, including 32 tables and appendix (mimeographed).

This monograph is another of the Treasury Department's planned series of excise tax studies with the principal objective of providing factual information on possible revisions of the Federal tax system. No explicit policy recommendations are formulated. The study, prepared by the Excise Tax Section of the Division of Tax Research, is as good a factual presentation of a complicated subject matter as is available. The principal parts of the study cover respectively Federal excise taxes on distilled spirits, fermented malt liquors, wines, rectified spirits and wines, and a brief comparison of Federal liquor gallonage taxes in the United States with those of Canada and the United Kingdom.

The real contribution of the study, in the opinion of this reviewer, is the assembling from scattered sources of factual data on the Federal liquor taxing system, changes in the tax laws in convenient tabular form, revenue collections (1936-1947), and the economic background of the liquor industries. Definitions of the Federal liquor taxing bases are given clearly and concisely so as to offer a liberal education to anyone not technically versed in the Federal liquor taxing statutes.

The $9 per proof gallon tax on distilled spirits is now the largest single source of Federal excise tax revenues. The $8 per barrel beer tax ranks third in revenue importance; the cigarette excise takes second place. The wine taxes, the rates of which vary with the type and alcoholic proof, and the rectification tax of 30 cents per proof gallon produce small revenues as compared with collections from distilled spirits and beer taxes.

The competitive and monopolistic aspects of the various liquor industries are examined. On the supply side, the increased concentration of the straight and rectified whiskey industries, the fairly low degree of concentration of the beer industry, and the centering of the domestic wine industry in the eastern states and California are noted.

The study points out the significant switch in consumption to blended whiskies (about 90 per cent of the whiskey bottled in 1947 as compared with about two-thirds in pre-prohibition days). Whether for most of the war and postwar periods consumer expenditures exceeded the increase in levels of income, despite the highest gallonage tax on record, seems to the reviewer worthy of more analysis than accorded by the study. It is not a fair criticism of the study that it excludes state excises on distilled spirits, but a real need exists to determine whether the breaking point of increase in liquor tax revenues of both the Federal and state levels of government has been reached in view of the fact that many states have increased tax rates this past year with declining yields.

Profits in all branches of the liquor industry during the war are reported at high levels. Except for the wine industry, the study considers that profits may continue at high levels with existing tax rates, on the assumptions of avoidance of overproduction and continuing high consumer incomes. Since the taxes are levied at flat specific rates, competitive cost advantages for certain producers occur. The regressive nature of the liquor taxes is distinguished for different classes of consumer groups.

The sections on administration and compliance are the weakest parts of the study. Illicit traffic and bootlegging are generally regarded as dependent on factors other than the level of Federal tax rates, assuming no return of prewar conditions. A reduction in taxes may be indicated should the levels of income and employment decline, but the study does not expect that a rate reduction would increase revenues by reason of less evasion. The restricted scope of the Bureau

of Internal Revenue's prewar controls, now reinstated on cessation of the wartime controls in 1947, and the varying enforcement problems of the different liquor industries are examined.

The study covers in a general way several technical problems, relating to justifying retention of the floor stocks taxes on the occasion of increases in tax rates, to restricting refunds when wartime tax rates may possibly be decreased, to retaining the present drawback system of allowing a $6 refund to non-beverage producers, to rearranging the varying wine tax rates, and to making imported beer subject to the domestic excise tax.

The last part of the study notes the difficulties of comparing rates of taxation in the United Kingdom, Canada, and the United States.

The study is a commendable example of avoiding guesswork and bias when examining the Federal liquor taxing structures and rate levels.

ORBA F. TRAYLOR
University of Missouri

The Property Tax as a Fiscal Instrument in New York State. By M. SLADE KENDRICK, with the assistance of WALLACE H. STREVELL. *The Potentialities of Local Non-property Taxes as Fiscal Instruments in New York State.* By MABEL L. WALKER, assisted by WALTER COCKING. (Staff Studies Nos. 7 and 8 of the Fiscal Policy for Public Education in New York State. Auspices of the New York State Educational Conference Board and Public Education Association of New York City.) Pp. 47.

The first report describes the relative and absolute importance of the property tax as a source of state and local revenue in New York in the past. An attempt is then made to form a basis for estimating the probable size of the property tax base in the future. Charts are drawn to trace the relationship between changes in the full valuation of taxable property and changes in U. S. wholesale prices, income from incorporated and unincorporated business, national income, new dwelling units, the value of private construction, and the cost of building a six-room frame house in St. Louis. The data point to a great increase in the full valuation of taxable property in the next ten or fifteen years. The report concludes with a list of recommendations for improvement of assessment.

Increases in property assessments are slow to come about, however, and the second report examines the revenue possibilities of the permissive taxes authorized in New York in 1947. The estimated yield of non-property taxes now authorized for counties and cities in New York is $189 million. The estimated yield of local income and cigarette taxes, now authorized in certain states but not in New York, is $120 million.

Taxation Statistics, 1948. Taxation Division, Department of National Revenue, Canada. Ottawa: King's Printer, 1948. Pp. 185. 50 cents.

This is the third annual volume of a series. It presents data on collections from individual and corporation income taxes and succession duties and summarizes statistics compiled from tax returns. The corporation data include selected balance-sheet and income-statement items for 1946, classified by industry and by provinces. The individual income tax statistics are drawn from a 10 per cent sample of returns for 1946. Useful features of the compilations include a detailed breakdown of lower-income returns, tabulations by occupational groups, and tabulations by cities as well as by provinces. Comparable data on some of these points have not been available from United States tax returns. The present volume should be of interest to economists and statisticians working in the field of income distribution as well as to tax experts.

Report of the New Hampshire Interim Committee on Over-All Taxation. Concord, N.H., January 20, 1949. Pp. 56 + appendices.

This volume is the report of a committee created by the New Hampshire legislature in 1947 " to study all phases of taxation " in the State and to make recommendations for revisions and new sources of revenue. The committee's examination of the State's revenue system led it to the conclusion that New Hampshire has relied too heavily on taxes on liquor, beer, tobacco, and pari mutuel betting, which are too narrow in coverage and unstable in yield. It opposes further use of these taxes and also opposes other specialized taxes such as those on luxuries, meals, and soft drinks.

The committee's principal recommendation for new State revenue is a gross income tax at rates ranging from 0.25 per cent to 1 per cent on various occupations and businesses. If such a tax should be considered unconstitutional, it recommends a 1 per cent retail sales tax and a 1 per cent corporate and individual net income tax, with gross and net income defined in the same way as in the present Federal tax.

For local governments, the committee recommends full-value assessment, modifications in the tax on machinery and the poll tax, and legislation permitting local admissions taxes. It opposes permitting the localities to impose sales, income, or payroll taxes.

NTA NOTES

1949 CONFERENCE

MEMBERS of the Association who were present at the last year's meeting of the National Tax Association will recall an announcement that the Forty-second Annual Conference on Taxation will be held in Boston, Massachusetts on September 19 to 22, 1949, with headquarters at the Hotel Statler.

Rates at the headquarters hotel, in which ample accommodations are being held in reserve, are currently quoted as follows:

Singles	$4.50-$6.00
Doubles	7.00- 9.50
Twins	9.50-14.00
Suites	17.50-27.50

There are several other excellent hotels within easy walking distance of the Statler, and their rates will be furnished on request. Hotel reservation cards will be sent to members about two months in advance of the Conference.

Planning of the Conference program is now progressing under the direction of C. Emory Glander, Tax Commissioner of the State of Ohio. If you have not already done so in response to our postcard inquiry concerning the Denver Conference, you are cordially invited to send to Commissioner Glander or to the secretary's office any suggestions you may have with respect to the program.

Commissioner Henry F. Long, acting as Chairman of the Local Arrangements Committee, is preparing with customary vigor an entertaining and educational round of extracurricular activities. Those of you who know the beauties of New England and the delightful climate of the early fall will know why we expect this to be one of the most successful Conferences that has been held under the auspices of the National Tax Association.

RONALD B. WELCH
Secretary, *National Tax Association*

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